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New England Journal of Entrepreneurship

Summer 1998

Volume 1

Number 1

Feature Article

The Entrepreneur

Stanley I. Mason, inventor, holder of numerous patents,
and entrepreneur extraordinary

Refereed Articles

Franchising and Entrepreneurship: High Reward or High Risk?

Gad J. Selig

Customer Service and Satisfaction: Competitive Advantage and Beyond

Stanley Bazan

Redefining Loyalty: Motivational Strategies and Employee Loyalty in an Era of Downsizing

Sandra Obilade

Value Creation in New Firms: Evidence from the Biotechnology Industry

Joseph E. Coombs and David L. Deeds

Case Study

Paint-Your-Own Pottery

Lisa Morin



New England Journal of Entrepreneurship

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From the Dean 2
Benoît N. Boyer, Ph.D.

From the Editor's Desk 3
Laurence M. Weinstein

The Entrepreneur 5
Stanley I. Mason

Franchising and Entrepreneurship: High Reward or High Risk? 13
Gad J. Selig

Customer Service and Satisfaction: Competitive Advantage and Beyond 23
Stanley Bazan

**Redefining Loyalty: Motivational Strategies and Employee Loyalty
in an Era of Downsizing** 31
Sandra Obilade

Value Creation in New Firms: Evidence from the Biotechnology Industry 43
Joseph E. Coombs and David L. Deeds

Paint-Your-Own Pottery Case Study 55
Lisa Morin

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New England Journal of Entrepreneurship

From the Dean

Dear Reader,

Welcome to the *New England Journal of Entrepreneurship*, a new journal published by the College of Business at Sacred Heart University. This journal will emphasize articles about applied research and cases or exercises on entrepreneurship. We also will feature articles by real entrepreneurs.

This is an exciting moment for our College of Business. With the change in the University structure, we now face new challenges and opportunities. Entrepreneurship is a quality that we must have ourselves in order to continue to offer better programs. This journal is another sign of the improved quality of what we are doing.

I would like to thank Laurence Weinstein and Madan Annavarjula for putting this first issue together. They have done a great job.

I also invite you to submit articles for our next issue. Submissions will be judged in a blind review process. Preference will be given to articles about business ethics, global markets, and technology in a small business environment. Please follow the guidelines for submitting all material.

Thank you.
Benoît N. Boyer, Ph.D.
Dean of the College of Business
Sacred Heart University

New England Journal of Entrepreneurship

From the Editor's Desk

What used to be known in these parts as *Vanguard: The Connecticut Journal of Small Business* has now metamorphasized into a publication with a more global agenda and regional interest for entrepreneurial activity.

Dr. Madan Annavarjula, the Assistant Editor of NEJE, and I evaluated where we stood with our Vanguard experience since the journal's founding at Sacred Heart University in 1988. We both felt strongly we needed to change the vision and scope of the publication in order to position the journal for the next millenium and fit more comfortably into the University environment where the College of Business seeks accreditation in AACSB orbit.

If you would like to be considered for our Editorial Review Board or be placed on the Reviewer Panel, please let us know. Article submissions are currently being taken for the next issue. For specifications on sending a paper for possible publication, see page 4. We wish to expand our outreach through this publication and the Internet to obtain a global readership and following.

Any comments you would like to direct to us would be most appreciated.

Yours truly,
Laurence Weinstein
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The Entrepreneur

Stanley I. Mason, Jr.

Stanley I. Mason, Jr. has had an incredible impact on our lives. This article describes his journey to becoming an inventor and entrepreneur.

Entrepreneur is a title given rather freely to any person who directs his¹ own work. An entrepreneur may take direction from another, but not easily. I learned that I did not take direction easily from others and that I did not "fit" well in a corporate cubicle. After many tries I have been a successful entrepreneur for the last thirty years.

From my experience I've learned that entrepreneurs don't accept anything blindly. Entrepreneurs always run directions from another through their own filter and accept, reject, or partially reject, one or the other depending on his or her own belief system. They don't accept anything as gospel. They always have an on-going internal dialog to help make decisions of which way to go.

These are the reasons it is so difficult to be an entrepreneur. There are no "givens." Every choice is carefully considered and judged... not by what is right or wrong, not by "what is best for me?" but what is the best choice in this situation, at this time, with all the present aspects in place.

The entrepreneur is one who lives fully, eating all kinds of foods, dancing all kinds of dances, and traveling everywhere possible in the world. He talks to everyone as a long-lost friend, telling his secrets easily. He sings all kinds of songs and makes up his own puzzles to solve by himself.

The entrepreneur loves everyone and especially one person. He is difficult to love, though, because he is different every day and every hour.

The entrepreneur makes decisions quickly because he resolves each question down to two choices, then picks the choice he personally likes. If he finds that the choice is wrong after a while, he changes to the other choice.

The entrepreneur spends money quickly because he knows the world is filled with many opportunities from which he may choose. He chooses quickly, also for the same reason.

The entrepreneur is a great reader and student. He knows there is a world of information and secrets in publications and reads voraciously to gain knowledge and advantage.

The entrepreneur doesn't engage in gambling, doesn't join any game he cannot win. He works for advantage. He can imagine a building or structure or a giant company, then actually draw it and create it. The entrepreneur can create a thought for changing the future. He knows how to present the thought to others and have them enthusiastically tackle and physically complete the thought in real time.

The entrepreneur is always the same: as a child, as a student, in college, or working for somebody else.

The entrepreneur can understand his own thoughts and make things work for himself or for others of their choosing, even if it makes no sense to anybody else.

My own experience as an entrepreneur began when I was a senior in college and my intended, Charlotte, had just graduated. I proposed marriage and she responded with a conditional "yes." "Get a better job and the deal is done!"

I immediately quit my night job in Trenton's (New Jersey) Free Public Library, and analyzed the organizations in Trenton.

I selected John A. Robeling's Wire Mill and telephoned them. They said they had no jobs, but suggested I call the American Steel and Wire Company across the street from Robeling's.

I called American Steel and Wire and was invited for an interview. I could do many jobs because my father, who had his own electrical business, trained me. He taught me carpentry, and many other jobs.

American Steel and Wire's master mechanic, the person who kept the factory running, fixing all

that did not work, interviewed me. The interview took place in his office, which had a drafting board and a T-square but no draftsman.

I was hired as a draftsman and became a very good one.

In two weeks I drifted around the factory alone. I learned about the products the company made—cables to build bridges, airplane control cables, and everything else made of wire.

I soon realized that a man guided big vertical spools of wire with a stick into the diamond die. When the spools were full, the diameter was big and one rotation pulled a lot of wire through the die. A half-hour later, the spool was newly empty and the wire zapped through the die. The wire had one speed, yet it rotated differently.

I had just bought a level-winding fishing reel and immediately saw the connection between the hank's speed and the fishing reel. I talked to my boss and made a sketch for him. The boss told me to take the drawing down to the shop and have them build my machine.

I did take it to the shop and they followed that nineteen-year-old's sketch and made a big machine, 5 feet square, out of angle iron and diamond floor plate.

It worked great! The guy with the stick got another job.

I realized that though I had solved the feed problem at the die, my machine went too fast. I went to a junkyard and bought a '32 Plymouth's three-speed transmission. I owned a link-belt variable speed drive and I had the shop put a 5-hp electric motor on the variable speed transmission, and the three-speed Plymouth transmission on the other end. That also worked.

I then had them put the motor and transmission together with the much enlarged fishing reel and it worked very well.

Enough said. The factory multiplied my machine ten times and all went well! The people in the wire drawing department were all happy and I was invited to eat my sandwiches with the men on the factory floor.

The factory received its new materials in the shape of large rolls of ¾-inch diameter "rods" containing about 200 feet per roll. Each rod had to be carried by a tractor from the warehouse, a big undertaking because it weighed over a ton.

I thought, if you built a rail on the left wall and another on the right wall, you could put a moveable crane on top and run it up and down

and back and forth with a control button on a wire. You could pick up a roll of wire and a man could pull it from one end of the warehouse himself... over the top of all the rolls on the floor of the warehouse.

I made my sketch and again the boss said, "Make it." So I did.

About this time World War II started in earnest and women were hired to work. The factory had no toilets for them, so I sketched a bathroom with fifteen stalls. Where to put it? I designed poles (over the machines) and built the bathroom in the air! It worked.

I learned that half the number of women required twice the same number of toilets that the men did. A real formula.

I realized that I was able to visualize in my head different views of things that didn't exist. I learned to make drawings of these thoughts in such detail that I could explain to supervisors things which had never been made.

This fact is very important to entrepreneurship. As an entrepreneur I realized I had great power. I could think about a new product or a way of accomplishing a task, then sketch it in such a complete way as to convince another person that the thought could work, that it was practical and moreover, useful and of such value as to demand to take action and make it in three dimensions.

While I was still a senior in college, Pearl Harbor occurred. My whole class was motivated to join the service. I always wanted to fly, so I went to town and joined the Naval Air Corps. I was not to be called up for active duty until graduation—about three months.

Later, I was walking by a store window when I spied a drawing of an aircraft carrier, with an airplane spiraling down to land. Suddenly I thought, "What if I'm flying out over the ocean and return to the aircraft carrier out at sea, and it is not there?" I immediately went to the Army Air Corps recruiting office and joined up. The navy never said anything. Neither did I.

My wife got a job teaching third grade. I graduated from college and went into the Air Corps—where I learned to fly. It was a great experience. I was made an instructor because I had a fresh degree in teaching and it was just what was wanted.

My wife gave up teaching school and joined me in Alabama, where I was teaching flying. She gave birth to our first son there.

One day she asked me to put the diaper on the baby. I held up the cloth diaper. It was square. I looked at the nude baby. The baby was round. I realized it was an engineering problem to put on the diaper. It didn't really fit. This was a problem I solved later on.

Three years later I read an ad for an engineer in a St. Louis newspaper. It was placed by Glenn L. Martin, the aircraft pioneer. I answered the ad and was invited for an interview. I was hired and immediately began the paperwork to be released from duty. I was director of training for a whole airfield, Scott Field in Illinois, so the release process took some time.

My wife and I were living in a new house trailer on a farm across the road from Scott Field. Suddenly the 5 acres next to us was declared excess and the barracks were removed. It left long rectangular concrete pads scattered around with asphalt roads connecting the pads, with fireplugs here and there.

This is another example of where the spirit of entrepreneurship showed itself. I thought what a great trailer park this would make. We could put the trailers on the concrete pads then build bathrooms and a laundry building and rent out all the pads. Another first lieutenant, Bill, lived in a trailer. We formed a fifty-fifty partnership and began work.

The first problem was the land. We decided to lease it. The second problem was water. I opened a manhole cover in the highway across the road and found a valve down there. I climbed down and turned it on. The water went out and over to our property and fireplugs spouted water. We turned them off and, installed some spigots on each one, and there was water to every pad.

Soon my partner and I began to erect the laundry buildings. While we would do our required flying each day, we became impatient to land. We were anxious to go back home to work on the trailer park.

But Bill and I would argue about every point where a decision was required. It truly slowed us down, almost to the point of wanting to quit the partnership.

One day we were on the roof of the laundry building, fighting as usual. This time we were at odds over whether the eaves should be long or short and whether they should extend out to carry the water or be shorter to save material.

I thought of a solution. I realized we were losing time arguing over each thought. I turned to Bill and said, "Let's discuss each point. You pick your decision. I will think about the point and pick my decision. We will discuss the plusses and minuses of each way, yours and mine. If they are the same, we will go ahead. If they differ, then we will flip a coin, heads for my idea, tails for yours.

"We will proceed this way. If it turns out that your idea was better after trying it, we'll change our thinking and review the way we are doing the tasks." It worked and we doubled our speed and completed the whole project using this conflict-resolution method.

About this time I got the Martin Aircraft offer and arranged to leave Scott Field. Bill and I added up our costs and my partner paid me \$2,700 for my share of this investment. The park was worth about \$30,000 at this point.

I pulled my trailer to Baltimore where Martin Aircraft was located. In three days we were in Baltimore. I picked up my mail at the company's headquarters. There was a letter from Bill.

The morning after we left he had heard water running and stepped out of bed up to his knees in water. The Mississippi River had quietly overflowed its banks 20 miles upstream and had backed up onto our 5-acre plot. Five acres of water, 6 feet deep, covered his trailer park. There was water everywhere!

Meanwhile, when I reported for work at the personnel office, I was told the job I had accepted no longer existed. The only position available at the company was an hourly job that paid \$1.35 per hour. When I told the personnel office staff I'd take it, they were flabbergasted. I was taken to a large engineering room with two hundred draftsmen, all working silently.

After working three days in that room, I realized that 90 percent of the draftsmen there were bald. I thought, "Must I stay here till I'm bald?"

I got permission from my boss to go to the personnel office where I told of my unhappiness. They suggested I take a battery of personnel tests to determine where I should be placed.

After scoring well on the tests, I was transferred to their training department and given a raise. After a year my boss, Norman Johnson, told me the company was in bad shape and that soon I would be laid off. He offered to help me find another job.

In preparation for creating my resume, Johnson suggested I take 3 x 5 cards and make a pile of the things I could do with some experience. I made almost one hundred cards with things like painting, drawing, plumbing, carpentry, running lathes, casting, metal, etc. I made another one hundred cards of the things I would like to do—things like writing ads, writing biographies, working in libraries, etc.

Then Johnson and I searched all kinds of industries for the type of company I should work for and the positions I should apply for. We made a list of one hundred companies and jobs then settled on five. Armstrong Cork, the linoleum company, was on the top because Cameron Hawley was the head of advertising, and Johnson and I agreed that I should be a copywriter of industrial ads for a consumer company with industrial products.

I drove 80 miles to Lancaster, Pennsylvania, where Armstrong Cork was located. At lunch in a Lancaster hotel, I talked to the restaurant cashier about Armstrong and learned that it was the biggest company in Lancaster, was privately owned, and had a great reputation.

I drove to Armstrong's headquarters, went in and said hello to the woman at the front office and asked to see Mr. Hawley. She told me that I needed an appointment to see him. So I sat in the front office and watched the inside door of the office down the hall.

Pretty soon a tall man came out and went to the men's room. I got up and followed him.

While he was washing his hands, I said to him: "I'm here to see you, but the lady said I need an appointment!"

Hawley said, "Follow me, young man; I have a few moments."

We went out the door together, past the woman who tried to keep me out. He took me to his large office inside the big doors. His desk was gigantic—about 6 feet by 10 feet—with not a thing on it.

Hawley offered me a seat and asked me what I wanted. I sat and told him I wanted to work with him. He had just written and published *Executive Suite* which was being made into a movie. I'd read the book. It was about Armstrong Cork, but modified.

"We only hire people who come to us through the personnel department. But why would I even hire you? What can you do?" Hawley inquired.

I pulled out my pile of 3 x 5 cards and laid them out on his desk, row on row, and explained each one. Then I pulled out the other stack of what I wanted to do, and explained each of those to him.

Hawley sat back, then said, "Go down the hall to personnel and ask for Mr. Mason (no relation) and tell him I've hired you." We never talked money. I went down the hall and into personnel and met Mason. I told him what Hawley said.

"Young man we don't do it that way, said Mason. "We have a mansion—Armstrong Mansion—and we put all executive trainees there. I see you are married. We don't allow that. Mr. Hawley knows this."

"But," I said, "He said he had hired me."

Mason called Hawley and they talked and talked. In the end Mason had me fill out some forms then sent me back to advertising and Hawley.

I was given a glass cubicle, a desk, a typewriter, and a chair. I was introduced to Mr. Minet, my new boss, who gave me an assignment... to write a paragraph for an ad. I drove back to Baltimore and told my wife the good news.

Over the next week I wrote and rewrote the paragraph with "square copy" for Minet, and learned how Armstrong created advertising copy. I worked all day and night on ad copy and became quite expert.

One day Hawley and I happened to be in the men's room again. "I'm glad I saw you. We need to begin your company training and I want you to go to New York to see our advertising agency," he said.

A week later I took a train into New York City, and visited BBD&O, Armstrong's advertising agency, where I was to see Bruce Barton, the president.

I showed up at 8 AM but nobody was there except the janitor. I sat in the waiting room until finally he asked, "Who do you want?"

"Mr. Bruce Barton," I said.

"Why didn't you say so? Mr. Barton is in his office. It's right over there," said the janitor.

I walked over and opened one of the tall double doors, into a room 100 feet by 40 feet. Behind the desk was a white-haired, little man. He stood up and invited me in.

I walked to the desk. There were no carpets and my shoes made a loud click-clock sound.

Barton walked around the desk and we shook hands. I told him that Hawley had sent me to meet him.

I stood with Barton behind his desk. From wall to wall and floor to ceiling there was a large photo of the beach at Coney Island, with at least a million people all in their bathing suits looking at the camera.

Barton, with a sweep of his right hand, pointed at the crowd. "Here is your public... the people you write to. Don't forget it!" He told me about advertising and about TV and its future.

Seven months later, back at Armstrong, Hawley called together his twelve trainees and said, "We're going to have a contest. Imagine that I've invented a new product. It's a metal strip glued to a cork base. Please create an ad for this product." That's all he said, except that we'd have a review in six weeks. I had an evening assignment.

My days were taken by reading hundreds of one-hour plays that the Armstrong Theater was producing each week on network television. Several plays, which I picked, were produced and I went to New York to see them made. At that time, all television was live and it was quite exciting, especially to meet the actors. To be one of "the client's" people was a real thrill.

Meanwhile, I was working on my assignment. I named the product, developed specifications, and wrote the ads. There were 190 of them all typed and drawn according to Armstrong methods, with a signature at the right bottom of the page, with color illustrations of the product in use. It was a whole series of ads that told the product story.

The deadline came and we all went to the boardroom. Each trainee stood up and showed his ad and told his story. I was last because I was the newest person.

When my turn came, I opened my suitcase and pinned the ads on the wall around the room. It was quite a show, 190 full-color ads with copy beneath—all square copy, all with the Armstrong logo type. It looked like an ad agency presentation.

Hawley closed the meeting. No one said anything to me. I collected my ads and put them back in the suitcase.

The next morning I made an appointment with Hawley's secretary and saw him at 10 AM.

"What do you want?" he asked.

I said, "I realized yesterday that I'm much better than any of the people you have working as your trainees, and feel I deserve a raise."

"How much do you make?" he asked.

"\$485 a month," I replied.

He said, "What if I said no?"

I hadn't run this turn of events through in my mind. I said, "I hadn't thought of that."

Hawley stood up. "Good-bye Mr. Mason," he said.

Then he called in his secretary and told her that I'd be leaving. He had her set up a big luncheon for me and all of the employees in his department, 160 people.

It was a celebration luncheon. He told the group, "Stan Mason will never be happy in this department or this company. But we love him and wish him well!" The luncheon was terrific. It was a true celebration. But I was out of a job.

I called the Martin Company and asked for my previous boss. He was just about to quit his job to begin a new business and invited me to Baltimore. I immediately drove the 80 miles back there and was recommended to take his job.

I began work immediately, but also was interviewed for a public relations job, taking care of old Glenn L. Martin himself. I was responsible for writing news releases—but more especially I was to keep his name and pictures out of the newspapers and magazines. Martin was very newsworthy and attracted writers who wanted to link him with young actresses who appeared on his yacht.

I learned the PR business for about a year. One day I sat next to Palmer Calstrum while having lunch in the cafeteria. Calstrum was the man who had hired me in St. Louis.

Calstrum was looking for a person to promote to the job of chief of presentations at the internal advertising agency the company directed. I took the job and had one hundred writers and artists working for me.

I worked in this function for a year when my old boss, Johnson, called to ask if I would meet Orhum Small at a railroad station on the Pennsylvania Line toward New York.

I met Small and he told me he had a secret formula for a glue but didn't know what to do with it. (He was a VP of a large chemical company during the day.)

I began night work with Small, designing labels and writing detailed instructions on how to use the glue. Eventually I sold enough glue to

begin a business with Small. We rented a large empty store in Wilmington and went into business together and prospered, with me selling the glue all over the United States and hiring people to make, bottle, and sell the product.

That was the beginning of what is now Elmer's Glue, a white polyvinyl glue for book-binding and other uses. After three years I decided to go back to Martin because they wanted to hire me among thirty others to go to Florida and begin a new company making satellites. I sold my interest to Small and moved my family moved to Orlando.

In Florida I ran a large part of the company which we started in an empty hangar at the Orlando airport. We quickly hired many more people.

I was part of a team assigned to find and buy land on which to build a new factory. We bought 1,200 acres the same day Walt Disney bought his land for his new park. It adjoined Martin's land.

One evening one of the engineers held a great victory party outside. Suddenly we heard a radio announcement about Russia launching a satellite the size of a trolley car and that it was going to be over Cape Canaveral and Orlando in twenty minutes.

The group was electrified! We were working on a satellite the size of a basketball and here was a Russian satellite the size of a trolley.

We all ran outside and there was the satellite coming over the horizon, gleaming in the setting sun. It was twinkling and reflecting down on us. The party quickly broke up with all the people feeling dejected and defeated.

The very next day, Dr. Jerry Sarchet called from California and asked if I wanted to come to work with him and Norton Simon. I had worked with Sarchet in Baltimore, but had lost track of him after he left. He was now the psychologist at Hunt Foods.

I declined the invitation. I had read about Simon in *Fortune* magazine. He was known as the "wolf of Wall Street" because he was gobbling up small companies.

Sarchet called me three more times. The last time he invited me to visit California he said, "Why not come? You'll get a nice trip to California and a ride in the helicopter to visit Mr. Simon." So I finally accepted. Simon and his group of executives interviewed me for two days.

Simon asked what I wanted in pay. So I doubled my existing pay and Simon said okay. Then he drove me to the Los Angeles airport. We never did pick a job title or a job for me. He was just hiring talent.

I called Charlotte in Florida and told her we were moving to California. We now had four children and she wasn't very happy, but she did cooperate.

We went to California, built a new house, and I moved from job to job within the company, always reporting to Simon. I was in the advertising department, in charge of new products and special programs for Simon. We bought the Wesson Oil Company, *McCall's Magazine*, a railroad company, and several other smaller companies. I bought an airplane and flew it around California, landing at every airport. I even flew it to New York twice.

About this time I had been with Hunt Foods for five years, learning about all kinds of foods and packaging. One day Dr. Emile Libresco, who had been with Hunt Foods but left to go to the American Can Company, called me and invited me to join him there.

After calling me four or five times, he said, "How many national parks have you visited?"

"Two or three," I said.

"Make plans to visit all the parks across the country. We'll pay the cost," he said.

So with my family I drove across the country to New York, visiting national parks along the way.

American Can was located in New York, but had secretly bought land on the New York/Connecticut border and was about to build a new 2,000-person headquarters in Connecticut.

I assumed the position of vice president of Product Development, Advertising, and Public Relations. The R&D department was in disarray. It had 1,200 people working on 1,200 different projects.

I called a meeting of all the marketing VPs and asked them to prioritize all the projects, department by department. Then I assigned only the top five projects in each of the five departments, and made sure that was all they worked on. The confusion was worked out quickly and projects were quickly finished.

One of the projects I personally believed in was my own—the development of a form-fitted

disposable diaper. I designed the diaper, which created no waste in the manufacturing process. Then I developed the machinery, began marketing research, and had it patented.

One day the chairman called me to his office. I thought it was for raise. He said, "I understand you are working on a disposable diaper."

I said, "Yes."

"Don't you know that no one will ever use a disposable diaper?" He continued, "We got along without you before you came, and we'll get along after you leave. Good-bye."

I left the same day and called my wife. "It has happened again," I told her. She knew what I meant. I'd been fired. I asked her what we would do.

She suggested we go to Spain and sit on the

beach and decide what to do.

We did go to Spain. We did sit on the beach and we decided to begin our own company. We decided to divide our time in half, work on our own projects for half of the time and for clients the other half.

We converted our horse barn into a laboratory with tools and equipment and drawing boards. I set up an office over the garage.

Then the head of R&D at Johnson & Johnson called to ask if I would make a placenta basin for J&J. I did. He was the first client of Simco Inc., and that business relationship lasted for twenty years. For a listing of some of our clients, see Exhibit 1.

Since Simco's beginning I have invented over one hundred products, patenting fifty-five for the company's clients.

Exhibit 1 Partial Listing of Simco, Inc.'s Clients

Alcan-Canada	Surgikos	Procter & Gamble
American Can	Vision Products (Vistakon)	Cascade
Dixie-Marathon	Kimberly-Clark	Tide
American Hospital Supply	Depend	Reebok
Beecham	Kotex	Richardson-Vicks
Bridgeport/Stamford Hospitals	Lehn & Fink	Clearasil
Chesebrough Pond's	Minwax	Oil of Olay
Colgate-Palmolive	Lipton	Vicks
Crown Zellerbach	Knox	S. C. Johnson
F. X. Matt Brewery	Wishbone	Schick
Frito-Lay	Lohmans	Scott Paper
General Electric	Mason Research Foundation	Baby Fresh
Hill's Pet Products	Chinese Tallow Project	Simco
Science Diet,	McDonald's	Bio-Pot
Prescription Diet	Nestle	Masonware
Hoechst Celanese	Neutrogena	Patio Planter
Hunt Foods	Nike	Soft Sheen Products
Hydrodent Laboratories	Norwegian Cannery Association	Tetley
James River	King Oscar	Tupperware
Jet Dry	Pepperidge Farms	Syroco
Johnson & Johnson Companies	Playtex Family Products	Vasogen
Acuvue, Surevue, Band-Aid	Apparel Group (Sara Lee)	Velcro Fastening Systems
StayFree, Sure & Natural		Vidal Sasson

Endnote

1. For simplicity, use of the male pronoun is used throughout this article.

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Mr. Mason holds a number of U.S. patents. Among his most famous are: the form-fitted disposable diaper, a touch-responsive portable intrusion alarm, cooking vessels for microwave oven cookery, a disposable full-face surgical mask, ultrasonic sealing apparatus, sanitary napkins (four patents), and trash and garbage compacting systems.

Franchising and Entrepreneurship: High Reward or High Risk?

Gad J. Selig

According to the Department of Commerce, start-up, small, and family businesses are among the fastest-growing areas of employment. Even under the best economic environment, starting a business is risky. To reduce the risks and to establish their own businesses, an increasing number of entrepreneurs and corporate converts are buying franchises.

Franchising has enjoyed a major increase in popularity during the early 1990s, fueled largely by the growing pool of available candidates made possible by significant corporate and government downsizing. According to the Department of Commerce, franchising accounts for nearly one-third of all U.S. retail sales and employs over 7 million people.

If an individual has the motivation, skills, capital, leadership, entrepreneurial spirit, and risk-taking attributes required to start and manage a business, franchising provides a structured alternative to accomplish this objective. Franchising encompasses both high risks and high rewards. While it is not for everyone, franchising represents a method to start and/or transition into your own business.

This article describes the why, what, and how of franchising. It discusses the driving forces for franchising from both the franchiser's and franchisee's perspective, what it takes to be a franchisee, how to become an educated businessperson, what to do once you have selected a franchise, the do's and don'ts, the risks and rewards, and how to sell a franchise.

Restructuring of the workforce, corporate downsizing, and drastic cuts in defense and public-sector spending have caused significant worker displacement in the United States. According to the Department of Commerce, start-up, small, and family businesses are among the fastest-growing areas of employment.¹

Franchising represents a significant component of this growth. An estimated 540,000 franchises employ over 7 million people, which accounts for \$750 billion in annual sales and a third of all retail sales. With socioeconomic

changes continuing to create fertile ground for franchising, businesses are choosing to franchise with more individuals becoming franchisees. This article explores the why and how of franchising, the risks and rewards, and the do's and don'ts from both a conceptual and experiential basis.

What Is and Why Franchise?

In simple terms, "franchising" is a partnership between the franchiser and the franchisee. The franchiser contractually gives the franchisee the right to start and manage a franchise business according to certain rules and guidelines. The franchisee generally has the right, as an independent business owner, to manage and grow the business. As a franchisee, one has to pay dues (e.g., franchise fees, monthly royalties) which vary by franchise. These dues provide revenues necessary for the franchiser to operate and provide systems, training, marketing, promotion, and other services to all the franchise owners in the system.

According to the Department of Commerce, the following are some of the major reasons why companies decide to franchise.

- Franchising provides an effective method for raising capital to finance expansion.
- Franchising enables the franchiser to pool resources, advertise and promote, achieve economies of scale in purchases, expand internationally and develop new products and services.
- Franchising provides the franchiser quality control, consistency, and uniformity over goods and services produced and/or distributed as well as media, public relations, image and appearance.
- Franchising provides flexibility for responding to changing customer needs and emerging markets within a wide variety of sectors.

Individuals become franchisees for a number of reasons.

- Individuals, who want to become business owners versus employees, are not comfortable doing it alone, but are comfortable working within a framework such as a franchise.
- Individuals want to pursue the American dream of achieving high rewards through risk sharing in a quasistructured environment.
- Individuals want the benefits of a franchiser's name recognition, network, systems, training, and infrastructure to help establish and grow their business.
- Individuals may be able to obtain financing more easily from a franchiser than from other sources.
- Franchising helps individuals transition from corporate life to ownership of their own business.

Do You Have What It Takes to be a Franchisee?

Based on my own experience, the most important characteristics of a franchisee are a strong work ethic and a highly motivated, winning attitude. As a franchisee, you will have to put considerable entrepreneurial drive to work to grow your business. You should be prepared to work hardest during start-up. You have to be ready to handle long days (twelve to sixteen hours) and perform multiple functions, including sales, marketing, purchasing, accounting, systems, human resources, and customer service. Franchises are more likely to succeed if their owners are actively involved in the day-to-day business management, marketing, and operations in the initial stage.

According to Calvin Haskell, Jr., President of Franchise Solutions, a franchise advisory company, the best franchisees are those he refers to as "intrapreneurs." These people are driven by an entrepreneurial spirit to be profitable, yet also have the ability to work within a franchise system. The ideal is for people to be able to work within a structured environment. People who are too entrepreneurial just will not follow systems or guidelines of a franchisor.²

Exhibit 1 is a self-administered test, developed by Franchise Solutions, to help you

determine if you have what it takes to be a franchisee.³

How to Get Smart About Franchising?

To decide if franchising is for you and to become an informed investor (since you will be investing anywhere from \$25,000 to several hundred thousand dollars), you must become educated in the franchising field. You need to understand the pros, cons, and risks of franchising.

There are two aspects to franchising: positive and negative. The positive aspects depict success and lucrative financial rewards for people like Ray Kroc (McDonald's), Colonel Sanders (KFC), and the thousands of millionaires they have helped into business. The negative aspects remind us of the early years of franchising when con artists sold empty promises of phony fast-food success as aired in a 60 Minutes TV report entitled, "From Burgers to Bankruptcy" in 1978.⁴ Understanding both sides of franchising is critical to selecting the right investment for your interests, competencies, skills, and resources. Here are some steps to help you become better informed and better educated.

- Read books, periodicals, and other surveys (e.g., Dun & Bradstreet, Entrepreneur, Business Week) on franchising.
- Attend franchising trade shows and talk to franchisers in a variety of different products and service businesses. Obtain a copy of the Uniform Franchising Offering Circular (UFOC), a comprehensive disclosure prospectus made available to potential franchisees by franchisers you are reviewing. The UFOC contains much information about the franchiser, its key management group, fees to be paid (one time and recurring), the total estimated investment, key terms of the franchise agreement, the franchisor's financials, addresses of current franchise owners, purchasing and other restrictions, a list of franchisees who have left the system, and other information. In addition, a copy of all contracts and agreements to be signed by the franchisee are available. After reviewing

Exhibit 1

Self-test for Potential Franchisees

1. You own a company. How much operation detail are you comfortable with?
 - a. I want direct control over all operations.
 - b. I delegate less than half.
 - c. I delegate more than half.
2. You have three job offers with comparable salary and benefits. Choose one.
 - a. Small company but high management responsibility and exposure.
 - b. Mid-sized company with less personal exposure but more prestigious name.
 - c. Large company with least personal exposure but very well-known name.
3. You reach a major stumbling block on a project. You:
 - a. Seek help from others immediately.
 - b. Think it through and then present possible solutions to your superior.
 - c. Keep working until you resolve it on your own.
4. Which investment sounds most appealing?
 - a. Five percent fixed return over a period of time.
 - b. From -20 to +50 percent loss or return over a period of time, depending on changing economic situations.
5. Which business arrangement is most appealing?
 - a. You're a sole owner.
 - b. You're in a partnership and own a majority of the stock.
 - c. You're in an equal partnership.
6. Your company's sales technique increases sales 10 percent per year. You used a technique elsewhere you feel will result in 15 to 20 percent annual increases, but it requires extra time and capital. You:
 - a. Avoid the risk and stay with the present plan.
 - b. Suggest your new method, showing previous results.
 - c. Privately use your system, and show the results later.
7. You suggest your system to your boss, and he says, "Don't rock the boat." You:
 - a. Drop your different approach.
 - b. Approach your boss at a later time.
 - c. Go to your boss's boss with the suggestion.
 - d. Use your own system anyway.
8. Which would mean the most to you?
 - a. Becoming the president of a company.
 - b. Becoming the highest paid employee of a company.
 - c. Winning the highest award for achievement in your profession.
9. What three activities do you find most appealing?
 - a. Sales and marketing
 - b. Administration
 - c. Payroll
 - d. Training
 - e. Customer service
 - f. Credit and collections
 - g. Management
10. What work pace do you generally prefer?
 - a. Working on one project until it is completed.
 - b. Working on several projects at one time.

Scoring:

- 1: A=5, B=3, C=1
- 2: A=3, B=2, C=1
- 3: A=1, B=5, C=7.
- 4: A=2, B=6.
- 5: A=7, B=5, C=2.
- 6: A=1, B=6, C=10.
- 7: A=1, B=5, C=8, D=10.
- 8: A=8, B=2, C=5.
- 9: A=10, B=1, C=3, D=3, E=8, F=2, G=5.
- 10: A=3, B=6.

You would potentially be a good franchisee with a point-score range from 34 to 71.

Range	Comments
20 - 33	You're a corporate player, happiest in a structured environment.
34 - 71	You're a potentially good franchisee.
72 - 85	You're an entrepreneur, preferring total independence.

Source: Caffey, Andrew, "A Closer Look At Franchising," Entrepreneur, January 1996.

these documents and talking to franchisees, the following questions should be addressed to the franchiser or its representative:

—What is the management philosophy and culture of the franchise? How do you view the franchisees?

—What are the franchiser's plans for expansion? New products and services? Alliances? New marketing and promotion programs? New systems? Field support? Training? National programs?

—Is there a dispute resolution mechanism in place between the franchiser and the franchisees? Arbitration?

—Is there a franchisee owners council? How does it operate? What role does it play in the franchiser's decisions?

—What are the primary reasons franchise owners succeed? Fail? Sell?

—Has the franchiser made any oral promises that are not reflected in the written franchise agreement?

—What are your renewal rights? What conditions must you meet to renew your agreement? Renewal fees?

—Under what terms or conditions are you allowed to terminate the franchise agreement? Sell your interests?

—Where franchisers claimed earnings (Item 19 of the UFOC), ask the franchiser to provide more specific earnings information about other franchisees in your potential market. The law allows a franchiser to provide such supplemental earnings information outside the UFOC.⁵

- Contact franchise and small business consultants, lawyers, CPAs, business brokers, and financial lending institutions to learn more about various kinds of businesses.
- Visit franchisees (both successful and unsuccessful; the latter will be more difficult

to find) and ask these questions (similar questions should also be posed to franchise consultants, lawyers, CPAs, etc.):

—What were the gross sales over the last three years? What was your pretax net income? Is the franchise meeting your financial expectations? Nonfinancial expectations? Why? Why not?

—What is the most attractive part of the franchise? What is the least attractive part?

—If you had to do it over, would you still buy this franchise? Why? Why not?

—How would you evaluate the franchiser's pre-opening support programs such as training, location selection, grand-opening support, marketing assistance, operational support, etc.? How would you evaluate the post-opening support programs such as new marketing, product/service and support initiative, sponsorship of networking groups, national discount purchasing programs, quality assurance programs, advertising etc.?

—Contact franchisees who left the system to find out why they left and how the franchiser handled their departure? Did the franchiser help in the sale? Was it a dispute? How was it resolved?

- Contact these organizations for more information on franchise regulations, statistics, and trends:

—*International Franchise Association, Washington, DC.* Trade association for franchising.

—*Department of Commerce, Washington, DC.* Publishes statistical information on franchisers and franchisees.

—*Federal Trade Commission (FTC), Washington, D.C.* Provides information about franchise rules.

—*The American Business Opportunity Institute, Inc., Bethesda, MD.* Provides a national clearinghouse service for business and franchise opportunities, investments,

regulations, and publications.

—Surf the Internet for franchise information.

How to Select a Franchise Concept That's Right for You?

If you decide that franchising is right for you, one of your first decisions should be to select a business concept that you will be comfortable with and that will offer you the best chance of success.⁶ Factors to be considered are described below.

Type of Work

To be successful in business, you must enjoy working in the business. Pick a franchise that you are excited about going to work daily.

Specialized Training and/or Education

Some types of franchises require specialized training or education that cannot be provided in a few weeks. You should probably avoid such franchises if you do not have the specialized training or do not have the time to devote to the training.

Number of Hours/Days of Operations

Many businesses require that the facility be open late in the evening and/or on weekends (retail). If you want close-to-normal business hour operations, choose a franchise that provides them.

Number of Employees

Labor-intensive businesses (e.g., fast food) require many human resources issues ranging from hiring, retaining and training dependable help, complying with government requirements regarding insurance, benefits, etc. Many of these issues can be minimized by selecting a business that can be effectively operated by family members with the assistance of part-time help. Sometimes, this has both advantages and disadvantages. As the business grows, obviously the issues change.

Capital Requirements for Start-Up

The most common reason for business failure is under capitalization. The amount of capital required for start-up and the working capital were insufficient. Be certain to select a business that is appropriate for the capital you have available, which should include working capital to cover a six-month to one-year start-up period as well as capital required for equipment, supplies, inventory, consultation, and labor. Do not overextend yourself or incur so much debt that you will not be able to survive through the start-up phase.

Susceptibility to Economic or Seasonal Fluctuations

A business that provides basic products or services which customers will require in good or bad economic times offers leverage against economic fluctuations and often, even seasonal fluctuations. High-ticket items such as autos, luxury items, and travel are often curtailed during economic slowdowns, while food, healthcare, postal, and repair services tend not to be.

Product v. Service Business Orientation

Service franchises (e.g., education, telemarketing, postal services, quick oil change) are popular today as the economy shifts more to a service orientation.

Family Involvement

A growing number of franchisees combine their work and personal lives. Forty-two percent of franchises are purchased jointly by married couples. For some families, franchising may be very appropriate.⁷

Existing Support, Infrastructure, and Name Recognition

Buying into a new franchise system can be a terrific opportunity to get in on the ground floor. However, some new franchises do not yet have the marketing name recognition, nor do they have all of the support, training, and systems in place. Be extra careful when considering a new franchise.

My wife and I educated ourselves about franchising and investigated more than twenty-five different franchise concepts. We made a list of franchise selection criteria that we used in choosing a franchise. The criteria were based on previous work experiences, our likes, our competencies, capital requirements, and other considerations. We identified:

- *High-value added service-oriented business.* We were interested in taking advantage of the high-growth service sector.
- *Minimum capital investment.* We wanted to minimize our capital investments and established a range of \$100 to \$125K.
- *Business hours.* We wanted to invest in a business that had close-to-normal business hour operations while minimizing late nights and weekend work.
- *Pre-tax profit margin minimum.* We only looked at businesses with a 20 percent minimum pretax margin and a minimum annual growth rate measured in gross sales of 25 to 35 percent per year for the first three to five years.
- *Home office/small business support related.* In the early stages of home-based or small businesses, these companies outsourced many office, communications, and related support services. We were comfortable in this area and visualized it as having high growth potential.
- *Number one franchiser in chosen area with national name recognition.* We conducted a competitive analysis of the leading nationally recognized postal, business, and communications services providers (e.g., U.S. Post Office, Mailboxes, Etc., PAK Mail, Packaging Plus, Postal Annex, and others). Aside from the U.S. Post Office, Mailboxes, Etc. came out on top in several categories (e.g., largest number of stores, longest open, higher than average growth and profitability per store, excellent training programs, strong brand and name recognition). While their systems were inferior to other franchises at the time, they were undergoing major revisions.

- *Territory exclusivity and protection.* Most franchisers provide some sort of territory exclusivity determined by such factors as geography and/or population density.
- *High resale value.* The resale value of a business is determined by several factors, most of which are affected by how you grow and manage the business and its revenues, expenses, and profitability. In addition, the franchiser can influence the resale value by maintaining excellent marketing, brand recognition, finance, quality, communications and support programs, and minimizing turnovers and failures.
- *Buy an existing franchise or develop a new one.* We found that established franchises were generally more expensive and we were willing to take on the risks and challenges of starting a new business in a new location for a lower cost.

Once we selected a franchiser, we had to sell ourselves to the franchiser in terms of start-up funding, commitment, and abilities. Remember that the franchise system is designed to improve the odds of success by carefully screening, selecting, and training motivated individuals.

What to Do Once You Have Selected a Franchise

Once you have selected a franchise, reviewed the UFOC and related documents with your lawyer, and accountant, and put together a preliminary business plan with financials, you are ready to move ahead.

Mailboxes, Etc., the franchise we selected, is based on a three-tier structure. The first tier is the corporate franchiser, Mailboxes, Etc. The second tier is known as an "area franchisee." The area franchisee owns (buys it from the franchiser) an area and is responsible for developing and supporting it on behalf of the franchiser. The area franchisee is responsible for identifying new locations, selling franchises, conducting in-store training, and providing local or regional support. The third tier is the individual franchisee, who represents the revenue base of the franchiser. The steps we followed once we selected Mailboxes, Etc. included:

- *Signed a franchise license and paid franchise fee.*
- *Arranged for financing through private sources.*
- *Selected a location.* This is the most critical decision you will make in a retail franchise. The site selected must have significant traffic, be visible from the major roads, and have excellent parking facilities. Mailboxes, Etc. assisted us in the site selection by providing reports on population demographics and statistics, as well as competitors' locations. Once you have located the ideal site, talk to other storeowners about traffic, the landlord, facilities, and lease options.
- *Signed a lease.* We signed a five-year lease with annual renewal options after the first two years to give us flexibility.
- *Attended training.* Mailboxes, Etc. provided a two-week, mandatory training program which is paid for by the franchisee. The program was thorough and intense. It reviewed all aspects of the business. In addition to the formal training program, we participated in a one-week, on-the-job orientation in an existing franchise. This was extremely useful and informative.
- *Designed Store and Hired Contractor.* Part of the training program was devoted to laying out the store design and determining such things as counter and merchandise space. Once the layout was completed, corporate furnished the blueprints to build our store. We hired a contractor recommended by other franchisees in our area.
- *Developed marketing and promotion plans and programs.* We established a computer database, completed a direct mail campaign, advertised our grand opening in the local newspapers, and conducted a door-to-door flyer campaign of over 1,000 prospects.

Do's and Don'ts of Establishing Your Own Business Through Franchising

Once you have decided to establish your own business through franchising, there are a number of do's and don'ts to consider.

Do's

- *Do your homework.* Finding the right franchise requires a lot of hard work. You should conduct research; interview franchisers, franchisees, and other professionals; and evaluate complex legal documents.
- *Develop a pragmatic business plan.* Construct a three-year business plan with pro-forma financials, including cash flow statements. It is probably a good idea to develop three plan scenarios: optimistic, normal (or expected), and pessimistic.
- *Develop an actionable and flexible marketing and sales plan.* Establish annual and seasonal marketing programs to promote the business and create customer awareness and loyalty. Focus on customer acquisition and retention strategies, including database marketing, (one to one) frequent user discount programs, and special promotions. Be prepared to install marketing program measurement systems to assess results and change promotion and marketing programs and budgets. Where possible, incorporate market segmentation principles to better target and position.
- *Know your costs.* Establish and maintain a tight cost control system so that you can track the costs of and profitability of all products and services. This will help you manage your business more effectively and profitably.
- *Provide outstanding, courteous customer service and clean premises.* In a retail service business, providing excellent and reliable customer service and a clean environment is critical to the success and continual growth of the business. You should resolve all complaints quickly and fairly. You should minimize "wait time" for servicing customers. Get to know your customers, their businesses, and their special needs whenever possible.
- *Develop a contingency plan if things do not work out.* If the franchise does not work out, you should develop a contingency plan to minimize your losses by selling, relocating, or dissolving the business.

Don'ts

- *Don't get in over your head financially or operationally.* You must be realistic about how much you can afford on start-up and working capital, which should include debt payments. In addition, you should be comfortable in managing the business and not be overwhelmed by it.
- *Don't be penny-wise and pound-foolish.* If you are going to use the professional services of a lawyer, accountant, or other professionals, use the best your money can buy. Their advice can save you a lot of headaches down the road.
- *Don't assume franchising is easy.* Owning and managing your own business is one of the most demanding ways of earning a living. Most new franchisees find that there is a substantial learning curve involved (e.g., six months to one year) before they are comfortable. Clearly, this is very much a function of the franchisee and the complexity of the franchise. Also, be prepared to work harder and longer than you ever have. You must consistently be proactive if you want the franchise to grow and prosper.
- *Don't get discouraged when business/competition gets tough.* Most businesses tend to be cyclical, with good and bad periods. If you encounter a slowdown and you cannot think of ways to change the downturn, call for help from other franchisees, the franchiser, and outside experts. You should carefully and deliberately examine all functions, processes, and strategies and, where appropriate, reengineer them.

How to Sell a Franchise

After five years of consistent growth and hard work, we decided to sell our franchise. We contacted the franchiser to determine what the franchise pricing guidelines were. We also talked to franchisees who recently sold their businesses. We learned that the pricing guidelines for a business were based on various criteria which ranged from multiples of net sales to multiples of pretax net income. We set a price based on a multiple of pre-tax net income plus the value of

existing merchandise inventory plus goodwill. Some of the selling strategies we used are described below.

- We established a fair selling price and added 20 percent to it to allow for bargaining leverage and potential sales commissions. We also established a minimum price below which we would not sell.
- We listed the business with both the franchiser and independent brokers on a nonexclusive basis. We prepared a "selling" information packet (e.g., audited financial statements, business plan, marketing plan) for use by prospective buyers. Over a four-month period, we successfully sold the business to a buyer who was introduced to us by the franchiser.
- We used our lawyer to draw up the selling contract. In addition, we had to go through a selling audit by the franchiser to assure that we had accounted for and paid all of our royalty and lease fees. We leased certain equipment and systems from the franchiser.
- Many sellers of small businesses have to partially finance the sale of their business over a five-year or longer time period. We chose not to finance and were able to get our full sales price up front. The franchiser provided financing to the buyer.
- We initiated the transfer of our lease to the new owner with the landlord.

Conclusions

Starting any type of business is risky, even under the best economic conditions. To cut the risks and facilitate the transition to your own business, an increasing number of entrepreneurs and corporate converts are buying franchises. Instead of starting a business from scratch, they buy a blend of individuality (own business) with the brand recognition, training, and established infrastructure of a franchiser. Generally, there are more expenses involved in franchising than in starting your own business.

Franchisees, like all business owners, can improve performance by carefully analyzing their competitors and customers. The better franchisers

are also proactively improving their relationships with the franchisees by listening more and acting on field recommendations for more effective marketing, training, and support programs.⁸

Despite the hard work and long hours, we found franchising to be a positive experience. We gained the confidence and knowledge of managing our own business. When the price and time were right, we sold the franchise.

As to the future of franchising and according

to studies published by Arthur Anderson, the International Franchise Associations, and the Gallup organization, franchising's potential is almost unlimited. Franchising is also growing internationally, primarily through the efforts of major U.S. firms such as McDonalds, Pizza Hut, Wendy's, and Mailboxes, Etc. According to John Naisbitt, author of *Megatrends*, "Franchising is the most successful marketing concept ever created."⁹

Endnotes

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Dr. Selig is also managing partner of Gad Selig & Associates, Inc., a consulting, research, and training firm that focuses on strategy, technology, and marketing topics and workshops for large and small businesses.

Customer Service and Satisfaction: Competitive Advantage and Beyond

Stanley Bazan

This article examines how excellence in customer service and satisfaction can be a major source of competitive advantage and profits for small businesses. The costs and causes of poor service and satisfaction are discussed and special emphasis is given to the value of the lifelong customer. Methods to pursue the goal of completely satisfying customers 100 percent of the time are examined. Leadership, aggressive problem solving, problem-solving teams, and assessment of customer service are among the topics reviewed.

In 1987, *Time* magazine ran a cover story entitled "Why Is Service so Bad?" In 1988, Bonnie Jansen of the U.S. Office of Consumer Affairs lamented that consumers are "sick and tired of being battered around; they're sick of getting poor service all the time."¹ Numerous articles on customer satisfaction and service appeared in publications like *Harvard Business Review* in the early 1990s and study upon study revealed that customers across a wide variety of industries reported low levels of customer service and satisfaction.

Most recently, joint studies by the University of Michigan Business School and the American Society for Quality Control reveal that customer satisfaction and service continue to be problematic in the U.S. economy.² According to these studies, overall levels of customer satisfaction have fallen in two out of the past three years and customers were less satisfied in 1997 with supermarkets, department and discount stores, hotels, and fast-food-type restaurants than they were in 1996.

Given the notion that the single most important ingredient in the success of a new venture is the customer³ and that customer satisfaction and service are among the most important factors affecting a business unit's performance,⁴ it is clear that satisfying the customer must be a primary objective of entrepreneurs. In fact, 71 percent of small business owners feel that customer service and

satisfaction is an area in which small companies can beat their big company rivals.⁵

Customer service and satisfaction represent a major source of competitive advantage for entrepreneurs because a properly focused small business is flexible and responsive enough to infuse the goal of completely satisfying its customers 100 percent of the time into all its employees and into every facet of its operations. Competitive advantage is defined in this article as the reason why a consumer would choose your business over another which provides similar goods or services.

This article begins by exploring the costs of customer dissatisfaction as well as some major sources of dissatisfaction and poor service. Next, a number of ways to achieve competitive advantage through excellence in customer satisfaction and service are reviewed. Goal setting, leadership, aggressive problem solving, problem-solving teams, and the assessment of customer service and satisfaction are also addressed.

Economics of Customer Dissatisfaction

A first step in pursuing competitive advantage through excellence in customer satisfaction and service is to fully understand the consequences of failure in these critical areas. The impact of poor service and satisfaction go far beyond the loss of a single sale, an unpleasant phone call, or a formal letter of complaint, and can have far-reaching impact on a firm's revenues and profits.

The direct financial impact of losing a customer can be astounding. For example, if your firm loses one customer per week for one year and these customers spend \$20 per week at the business, you will lose \$26,520 in revenues over the course of the year. If these customers spend \$50 per week, lost revenues total \$66,300; if they spend \$100 per week lost revenues in this scenario total \$132,600. Losing one customer per week who spends the relatively paltry sum of only \$5 per week for a period of one year would also yield a total loss of \$6,630.

The impact of losing a customer forever is also staggering when the economic value of a lifelong customer is considered. The lifelong value of a loyal pizzeria customer is estimated to be \$8,000 and the average lifetime value of a Cadillac owner to a dealer is \$332,000.⁶

In terms of direct financial ramifications, it is five times more expensive to get a new customer than it is to retain an existing one.⁷ Additionally, reducing the defection of existing customers can impact the bottom line as reducing defections by a mere 5 percent has been shown to increase long-term profits by anywhere from 25 to 85 percent.⁸

Less direct effects of dissatisfied customers such as negative word-of-mouth can also be significant. A landmark study conducted by the Technical Assistance Research Institute indicates that a dissatisfied customer will relate his or her bad experience to at least ten people.⁹ This study also shows that 13 percent of dissatisfied customers will tell their stories to more than twenty people. With whom will dissatisfied customers share their tales of pain and frustration? Both empirical research and conventional wisdom suggest the same answer—anybody who will listen! The fact that that consumers tend to give more credence to negative, as opposed to positive or favorable, word-of-mouth only adds to the detrimental effects of negative word-of-mouth.¹⁰

Another set of costs associated with dissatisfied customers, especially in industrial sales, is the time, energy, and potential legal bills that are incurred trying to collect payments from customers who refuse to pay for a product or service that they consider to be unsatisfactory. Lastly, valuable time can also be spent responding to government agencies or consumer complaint bureaus. Records of complaints maintained by these agencies also do little to enhance the reputation of a business.

Causes of Customer Dissatisfaction

Sometimes it only takes one incident in a trading relationship to turn a customer away from a business. Therefore, in analyzing causes of dissatisfaction it should be remembered that the entire chain of events composing a transaction as a whole may only be as strong as the weakest link.

Employee Attitudes

The first cause of dissatisfaction is rooted in employee attitudes. An attitude problem might entail indifference, lack of respect, or rudeness to a customer. Some examples are:

- On the way to take a fifteen-minute break, a salesperson in a retail store notices a customer straining to reach a large item on an upper shelf. The salesperson avoids making eye contact as she proceeds to the employee lounge.
- A clerk at a grocery store is more interested in conversing with his friend at an adjoining register and fails to credit several coupons appropriately. When the customer asks him to pay more attention to checking out the groceries, the clerk rolls his eyes and mutters something about "stupid coupons" under his breath.
- A customer with a new house is excited that her new dining room set is being delivered. She has been happy with the furniture store so far. When the delivery people show up one person does not take off his muddy boots and stains a carpet. The homeowner cleans the mud and looks for a new furniture store.

Employee Ability

Customers may also be dissatisfied when an employee is sincere but does not have the requisite knowledge or ability to properly serve the customer. These problems usually result from poor hiring practices or poor training programs. Consider these examples:

- A customer is frustrated with a salesperson's poor knowledge of the details of a special year-end inventory reduction sale.
- A person with extremely limited computer skills is assigned a sales position in an electronics department that sells a wide variety of computer hardware.

Rules and Policies

Company rules or policies might also cause dissatisfaction. These types of problems are usually the result of poorly conceived operating procedures. Problems of this type are often apparent when employees continually find

themselves telling customers "I would like to but I really can't." Several examples are:

Company policy states that a store will not accept personal checks for purchases over \$100. A cashier tells a customer that she can not accept a check for the \$104 bicycle that she was going to bring to her nephew's birthday party that afternoon.

- A customer comes into a hardware store with a broken rake and exclaims, "I bought this here last week and it broke after I used it for two minutes." The store manager refuses to replace the rake with an identical one that he has in stock because store policy states that a receipt must be presented when a refund or exchange is made.
- A store clerk can not assist a customer in the back of the store because she is the only one on duty and she has to watch the register.

Lack of Empathy

Lack of empathy involves the unwillingness to see the customer's point of view when it comes to service and satisfaction. This frequently leads to discounting the concerns of the customer as inconsequential and labeling potentially serious problems as "no big deal." Some examples are:

- A mortgage company calling a customer two hours before a scheduled closing and explaining, "We should be able to do this tomorrow afternoon because there are still some escrow issues that need to be resolved. It's not a big deal, this happens all the time." The customer immediately calls work to request another day off and nervously calls the baby-sitter to see if he could come tomorrow afternoon instead.
- A service manager at a car dealership tells a customer, "Just drop your vehicle off and we'll see if we can get to it over the next couple days."
- A contractor returning a phone call and telling a customer, "You only get one visit for a free estimate and I already explained the job to you. After all, installing a new sidewalk isn't a big deal and it's only a \$3,500 job."

Perceptions of Dishonesty

Seemingly dishonest business practices are another source of customer dissatisfaction. Although only a fraction of entrepreneurs are intentionally dishonest, it is important to recognize that exorbitant claims about a product, overly optimistic promises, and an unwillingness to give a customer bad news can all be perceived as dishonesty. Examples of activities that can be construed by customers as being dishonest are:

- The upholstery on this couch is so tough that it will not stain, rip, or require professional cleaning even if you do have three-accident prone toddlers.
- A dispatcher excitedly tells a customer whose copier has just broken down that he will have someone over within thirty minutes and that the repair work will only take ten minutes. The technician, who arrives on the scene after an 80-mile drive and then spends four hours fixing the machine, wonders why the individual in charge of the copier seems so irate.
- The account manager at an electrical supply house gets a call from a customer about an order that was supposed to arrive earlier that morning. He tells the customer that the order is "on the truck as we speak." The account manager hangs up and nervously calls his warehouse to see if the requested electrical components are in stock.

Towards Complete Satisfaction

Specific ways to build competitive advantage through excellence in customer satisfaction and service are explored below.

Goals

Developing appropriate goals and objectives is the first step in building competitive advantage through customer satisfaction and service. Although every business will be different in terms of specific performance objectives, there is little room for compromise in developing the overarching goal of the business. Every business

seeking competitive advantage through service and satisfaction should adopt the goal of completely satisfying its customers 100 percent of the time. Satisfying the customer means that a product or service and all aspects of the delivery of that product or service will always meet or exceed the customer's expectations. More specific operational objectives appropriate to a particular business must also support this overall goal.

Although the goal outlined above seems somewhat intuitive (especially given the costs of dissatisfied customers), the components of this goal statement warrant additional discussion.

First, notice the emphasis on complete satisfaction. A study examining the impact of various levels of satisfaction on consumer behavior was conducted by John Larson of Opinion Research Corporation in Princeton, New Jersey.¹¹ Larson examined the buying patterns of consumers who reported varied levels of satisfaction along the following scale: completely dissatisfied, dissatisfied, neutral, satisfied, completely satisfied. He found that completely satisfied customers were 42 percent more likely to be loyal customers than customers who were merely satisfied. Loyal customers represent repeat business and positive word-of-mouth which contribute to increased revenues. Completely satisfying customers and developing loyalty is so important that it is considered the most important driver of long-term financial performance for businesses of all sizes across a wide variety of industries.

Horst Schulze of the Ritz-Carlton Hotel Company provides an example for companies of all sizes: "Unless you have complete customer satisfaction—and I don't mean that they are just satisfied, I mean they are excited about what you are doing—you have to improve."¹²

The concept of satisfying the customer 100 percent of the time should also be addressed. Although this is challenging to say the least, a business can never be complacent because it only takes one bad experience to turn a customer, and potentially the ten people he or she might relate their experience to, away from your business for life. Consistency of effort is just as important as quality of effort.

Leadership

The business owner must emanate an almost evangelical zeal to the goal of completely satisfying the customer 100 percent of the time. Leaders must communicate the importance of good service and satisfaction to every employee in the company and must set an example for everyone in the organization to follow. Even if there is only an owner and one employee in the company, that single employee can be inspired by observing the owner's actions. Business owners must also recognize and reward employees who demonstrate a total commitment to customer satisfaction and service.

Aggressive Problem Solving

Given the tremendous costs associated with a dissatisfied customer, aggressive steps must be taken to turn a less-than-satisfied customer into one that is completely satisfied. This may involve taking a relatively minor financial setback in the short run but the long-term rewards of completely satisfying a customer are worth it. Examples of such actions are:

- If the customer in the earlier scenario comes into your store with a rake that broke after it was used for two minutes and he says he bought it in your store but does not have a receipt, you should replace it if you sell the product in question.
- If a customer complains that his pizza was delivered cold and the crust was burnt, the customer should be given a coupon for a free pizza. Remember, the lifelong value of a loyal pizza eater is typically about \$8,000 and by making the next pizza free you will not only impress him with your sense of fairness but you will get another shot at his tastebuds, too.
- If a customer is not happy with the repairs on his air-conditioning system, send a service technician to his location as soon as possible even if it means paying overtime and not charging for the second service call.

Since cash flow is always an issue in small business, one might question the above tactics as

being overly aggressive or "giving" away the store. However, given the direct economic value

of lifelong customers and the impact of positive word-of-mouth, these tactics, when applied with reasonable limits and with common sense applicable to the particular business and product, are appropriate in maximizing revenues and profits over time.

Entrepreneurs are also concerned that these strategies can result in being taken advantage of by dishonest customers and it is probable that *some* customers would lie to get a free pizza or a new rake at the expense of the seemingly gullible entrepreneur but this would be a very small minority. In considering specific responses to dissatisfied customers, the business owner has to evaluate the cost of being taken advantage of by an unscrupulous few versus the benefits of completely satisfying the majority of dissatisfied customers who have legitimate concerns.

In summary, when applied with common sense and reasonable discretion, the practice of aggressively seeking to completely satisfy a customer with a bad experience with a product or service will yield truly impressive financial results over the life of the business.

Empowerment

Empowerment is defined as the sharing of power with others.¹³ Entrepreneurs must give employees the discretion to do whatever it takes to make a customer completely satisfied. This means giving employees the discretion to solve problems on the spot. Business owners must also be ready to forgive mistakes when they share such power with employees or employees will become overly cautious and conservative when solving service or satisfaction problems. Remember that one of the safest moves an employee can make is to say "I would like to but I can't."

Problem-solving Teams

Problem-solving teams are groups who meet regularly to address on-going concerns in organizations. Depending on the company's size, at least one team should be composed to serve as a forum to discuss customer service and satisfaction issues. These teams should be charged with understanding the company's operations from the perspective of the customer. In very small companies, this team may just be the owner

and a handful of employees. In addition to fixing specific problems, these teams reinforce the importance of customer service and satisfaction in the company.

Assessment

Understanding your strengths and weakness in customer satisfaction and service is essential if you are going to effectively pursue the goal of completely satisfying your customers 100 percent of the time. A business needs to assess its performance in satisfaction and service so that action may be taken to remedy any problems and more fully capitalize on any strengths. Additionally, because only 4 percent of dissatisfied customers will directly voice their dissatisfaction to you,¹⁴ a number of diverse methods of assessing customer service are reviewed in this section.

Listening. Despite the fact that 96 percent of customers won't complain directly to you, listening to customer complaints is one way to identify service and satisfaction problems. Although this seems intuitive, managers need to apply some specific skills when fielding verbal complaints. First, you need to avoid defensiveness in order to really concentrate on what the customer is saying. This is easier said than done especially when a customer is complaining about the business that you have nurtured and built. Try not to take complaints personally. Secondly, try to ascertain the exact nature of the problem so you can correct it for this customer as well as for others. It is far better to know that a customer's chicken soup was cold and that the soft drink was warm than to only know that the meal was terrible. Third, when conversing with a displeased customer, you not only have to ascertain the cause and extent of the problem, but you should take aggressive steps to correct any problem to completely satisfy the customer. Lastly, try to understand a problem from the customer's point of view and be as empathetic as possible.

Listening to employees can also be valuable in assessing customer satisfaction and service. It is important to ask employees about customer satisfaction and service in order to get a different

perspective than your own. Additionally, when a business begins to grow, the owner may not deal

directly with customers so it is important that an owner solicits the input of those dealing directly with the customers on an on-going basis.

MBWA. The power of "management by walking around" should not be discounted in assessing customer satisfaction and service.¹⁵ MBWA simply involves making a deliberate effort to observe if customers are being completely satisfied with your business. For example, do customers look confused or lost in your store? Are there long lines at cash registers? Is your staff being courteous and helpful? Do customers look happy? Because the small business owner is usually extremely busy with a wide variety of responsibilities, deliberate efforts to attune one's senses to some specific elements of customer satisfaction and service can yield some interesting insights.

Surveys. The last method of assessing customer satisfaction and service involves the use of surveys. Surveys can take many forms but all are designed to evaluate general as well as specific sources of satisfaction and dissatisfaction.

Surveys can be conducted by phone, mail, or at the point of sale or purchase.¹⁶ Phone surveys are the most expensive but have higher response rates than mail surveys. The cost of point-of-purchase surveys is cheapest but response rates vary tremendously depending on the specific business. Additionally, some businesses are more conducive to immediate evaluation by customers than others. For example, restaurants can make heavy use of point-of-purchase surveys because the business transaction has been completed, while businesses involved in auto repair can not rely heavily on point-of-purchase surveys because it may take several days or weeks for the customer to evaluate the repair work.

When designing surveys, it is important to remember that the longer the survey, the less likely customers are to respond to it. Customers are busy and do not want to spend a lot of time filling out a survey. Secondly, questions may be open-ended or may require respondents to answer via multiple choice or some type of numerical scales. An example of an open-ended question is: "Why were you satisfied or dissatisfied with our service?" Common numerically based scales can be composed of levels of satisfaction or can require the customer

to indicate various levels of agreement or disagreement with specific statements in the survey.

A common scale directly addressing levels of satisfaction is the scale composed of these items: completely dissatisfied, dissatisfied, neutral, satisfied, completely satisfied. A scale that is typically used to measure agreement with a particular statement includes: strongly disagree, disagree, undecided, agree, and strongly agree.

Although designing surveys can be complex and has received only limited attention in this article, a good technique for small business people is to start a collection of satisfaction surveys that you can pick up at other businesses. In other words, do not try to "reinvent the wheel" by trying to set up a survey without a few examples. Review some existing surveys and then modify the questions and response formats to suit your specific needs.

Entrepreneurs should think about instances when they either responded to or ignored surveys of these types. For example, how many times would you have completed a satisfaction survey in a restaurant but they did not provide you with a pencil? Also how often do you ignore a survey because there is "nothing in it" for you?

One technique of generating responses is to enter people in a drawing or contest when they fill out a survey. This technique works well in generating feedback from satisfied customers but can sometimes further irritate dissatisfied customers. With respect to response rates, do not be disappointed in what may seem like a low number of responses. Draw on personal experience to devise ways to improve participation.

Conclusions

This article has explored the costs and causes of poor customer service and satisfaction. Special emphasis was given to the astounding costs of poor service and dissatisfaction as well as the staggering economic value of lifelong customers.

Employee attitudes, the lack of employee ability, restrictive rules and policies, and perceived dishonesty were identified as sources of dissatisfaction and poor customer service.

Methods to achieve competitive advantage by pursuing the goal of completely satisfying customers 100 percent of the time were also reviewed. Goal setting, leadership, aggressive

problem solving, and assessment were discussed. management by walking around, and the use of
Methods of assessment include listening, surveys.

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NEJE

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Redefining Loyalty: Motivational Strategies and Employee Loyalty in an Era of Downsizing

Sandra Oblade

Retaining employee loyalty after restructuring is a problem for all types of businesses. The major issue concerns how management and employees can establish a new, mutually acceptable "psychological contract" which ensures employee loyalty but not lifelong employment. Eighteen small businesses in Fairfield County, Connecticut, were surveyed to investigate loyalty and motivation after downsizing. A significant correlation was found between loyalty and motivation. Furthermore, several motivational techniques employed were inconsistent with employee needs. Suggestions are offered on how to retain employee loyalty.

One of the most prominent features of the global business environment that has continued to engage the attention of the corporate world since the mid-1980s has been the phenomenon of downsizing. This phenomenon, perhaps more than any other, appears to be a major factor in the on-going reexamination of the nature of the relationship between every employee and his or her work organization.

This relationship which is quite different from the formal contract between labor unions and management is generally known as the "psychological contract" or "corporate contract."¹ Unlike the formal contract that deals with such concrete matters as rate of pay, leave, health and retirement benefits, the psychological contract comprises the set of expectations that specify what the individual and the organization expect to receive from each other in the course of their working relationship.²

Obviously, it would be easier for the employer to violate the provisions of the psychological contract than the formal contract that the legal system recognizes. The major contention of those who stress the negative aspects of the new trend in downsizing or restructuring is that employers have accepted the "historical shift that has changed the rules of the game."³ They have unilaterally reshaped the psychological contract, especially with respect to

the issue of guaranteeing job security in return for employee loyalty.

Years ago when many employees signed on to work, it was for their total career in one organization. Recent events have made this somewhat inviolate contract of trust, loyalty and job security a thing of the past. Increasingly people are contract employees or temporary workers and change jobs on a regular basis. Employees now look out for themselves since they no longer believe that the company will look after them.

It was in response to global competition, unfriendly takeovers, leveraged buyouts, and the like that corporations decided to abandon the traditional practice of rewarding employee loyalty and good work with job security and generous profits.⁴

As companies begin to emphasize profitability, efficiency, and shareholder interests, measures which the psychological contract would permit them to apply only as a last resort became viable first options. Thus, workforce reduction and the replacement of permanent workers with temporary ones became the order of the day. Factories were closed or relocated to lower-cost countries.⁵ The perceived violation of the psychological contract became, for the individual employee, a question of the termination of the rule of "fair exchange."⁶

A dilemma faced not only by large bureaucracies but also by any organization that downsizes is how to be as fair as possible to employees whose jobs are being eliminated. A related issue is how to retain the loyalty of the remaining workforce and restore their sense of security. With downsizing seen as a competitive imperative by many organizations, it is an ethical challenge for the 1990s.⁷

From the point of view of the employees, their contributions under the psychological contract (e.g., effort, skills, creativity, loyalty) appear to be undervalued. In reaction to

management's action, the employees have very few options. They could not fight back by reducing their contributions with respect to such measurable factors as skills, creativity, and effort. The obvious casualty in the revision of this psychological contract is employee loyalty, a variable which, though difficult to measure, remains one of the most important prerequisites for a successful organization. In fact, loyalty has been described as "the glue that holds the organization together."⁸

Business Week has labeled downsizing "job death." It appears that no company, however loyal it has been to its employees, is immune to this phenomenon. As *Business Week* noted, "In a quest for efficiency and survival, many of America's corporate behemoths have been shedding employees at unprecedented rates." Topping its list of the twenty-five largest downsizings is IBM—the company once famous for its "no layoff" policy—with 85,000.⁹ Today, downsizing is deemed a prudent management option. Peak presented this "explanation" offered to her by one CEO: "If your competitors have downsized, but you haven't, then Wall Street will view you as behind the times and overstaffed to boot."¹⁰ Peak suggested that continual downsizing has changed the face of business more than all the management fads of the past twenty years. Downsizing has eliminated the traditional agreement between employee and employer that tied a good service to a promise of continued employment.

Probably as a result of poor communication, employees in the United States seemed to think that downsizing was a local phenomenon. As a matter of fact, European workers were also affected by downsizing. For example, the British company Barclays Bank cut staff levels by about 20 percent while Siemens, the electronic conglomerate, freed over 3000 jobs in 1993. The German company Mercedes Benz even trimmed its management hierarchy levels from seven to five.¹¹ All these reductions resulted in a decline in employee loyalty.¹² As Robbins reports, a 1993 study indicated that 77 percent of workers surveyed felt that there was less loyalty in the companies studied than in 1988. He further indicated that employees were 60 percent less loyal than they were five years earlier.¹³

The revision of the psychological contract by the employer was never intended to result in the

reduction of employee loyalty or a feeling of insecurity by the employee. In short, the unhealthy psychological contract that has resulted from downsizing was the last thing any organization that strives to remain viable would ever wish for. But the fact remains that employees today still feel a sense of betrayed loyalty when they lose their job or when they see colleagues lose their jobs.¹⁴

It is management's responsibility to ensure that decisions taken in response to the realities of the business environment do not adversely affect the psychological contract even when such decisions may result in the loss of job security for certain employees. This daunting task may not have a high success rate. As Schemerhorn suggests, "The management of psychological contracts is a difficult, but still essential, management task."¹⁵

Management does not want a situation in which employees operate under considerable stress. For one thing, efficiency and profitability cannot be achieved in an atmosphere of mutual distrust and uncertainty. Furthermore, a corporate image that suggests insensitivity with respect to employee needs is likely to damage rather than enhance the acceptability of the company's products. Thus, the apparent disagreement regarding the reasoning behind the concept of downsizing for profitability has a lot to do with how the employer balances the issue of providing job security in return for employee loyalty.

Attitudes toward downsizing often depend on how one is likely to be affected by the restructuring. In short, while higher executives who propose the exercise and shareholders who stand to profit from downsizing look forward to layoffs, company executives, especially middle-level managers, anticipate an impending downsizing exercise with trepidation. The fact that the stock market reacts favorably when companies merge or new chief executive officers committed to restructuring are hired illustrates the different attitudes held by beneficiaries and victims. However, one thing both the critics and implementers of downsizing agree on is that the era of job security as the natural reward for loyal service may be over. The fact that global competition has forced several companies to believe that "leaner is better"¹⁶ should not be taken as a rejection of the need for employee loyalty. It is the failure by companies to properly

communicate the rationale for downsizing and to actively solicit employee loyalty that may be held responsible for the perception that loyalty is irrelevant or even unwise in today's business environment.¹⁷

Purpose of the Study

In spite of the well-documented negative attitude toward downsizing, there is no clear evidence that the initial sense of betrayal felt by survivors would significantly affect their loyalty to the company in the long run. It should not be taken for granted that employees who have survived downsizing would actively engage in seeking alternate employment opportunities. In fact, many employees may achieve self-actualization within the company after downsizing. For one thing, every downsizing opens doors for other workers who may be motivated to live up to the new standards demanded by the company. Bigger responsibilities, more participation in decision making, and new benefits packages might even be so enticing that commitment to the company would increase.

This is not to suggest that downsizing will always result in higher productivity or efficiency. A recent article in *The Economist* reports that companies such as Delta Airlines and Ford have suffered in terms of efficiency and profitability because of downsizing. A recent survey by the American Management Association (according to *The Economist*) found that "fewer than half of those companies that had downsized since 1990 went on to report higher operating profits in the years following the move; even fewer saw improved productivity."¹⁸

Studies such as the American Management Association's seem to support the idea that "companies that have cut back and retrenched have seen frustration and lower productivity instead of higher efficiency and profitability."¹⁹ However, it is debatable whether studies that have found a drastic reduction in employee loyalty after downsizing may not have reflected the initial sense of outrage felt by employees on the sudden and arbitrary termination of the psychological contract which assured them of job security. If this were true, the external validity of such studies would be questionable.

Furthermore, the implementation of innovative benefit programs such as massage

therapy, weight reduction facilities, and child care may have positively affected employees' attitude towards management, making workers less suspicious of the employers' intentions regarding the future of individuals within the organization.²⁰ Somehow society has learned to live with downsizing; it has become clear that companies have to react to global economic forces and the revision of the traditional psychological contract which guaranteed job security is inevitable.

It is generally accepted that "an important OB [organizational behavior] challenge will be for managers to devise ways to motivate workers who feel less committed to their employers while maintaining their organization's global competitiveness."²¹

To the extent that several corporations started to take steps to rekindle employee loyalty a long time ago, there is no evidence that workers would not learn to adjust to the new situation and restore a level of loyalty acceptable to management.

In view of the influence of several intervening variables that have been introduced in the workplace after the first major downsizing about a decade ago, there is a strong suspicion that more recent studies may not come to the same conclusions as the earlier ones. The present study reported here tried to fulfill the need to investigate to what extent management's more recent measures might have influenced employees' attitudes by focusing on the research questions provided in Exhibit 1.

Exhibit 1 Research Questions

1. How loyal are the employees of the companies selected for this study?
2. To what extent will variables such as gender, experience (length of service), and occupation type affect the level of employee loyalty?
3. How has downsizing affected the employee's level of morale in the selected companies?
4. To what extent has management succeeded in motivating employees by the range of innovative benefit programs introduced by the company?
5. Is there a significant correlation between employee motivation and loyalty?

Methodology

The study sample consisted of one hundred employees drawn from small businesses operating in Fairfield County, Connecticut. The businesses included finance, retail, and service-oriented operations. The companies were selected on the basis of two main criteria. First, in order to ensure that the study would not be gender-biased, companies with a sizable percentage of female employees were included. Second, only companies that had at least one reported downsizing exercise within the last three years were included. Thus, only those who knew what it was like to experience downsizing either as victim or survivor would qualify as subjects. All the participants would be able to compare the organizational environment before and after downsizing.

From a randomly selected list of thirty companies, eighteen were randomly picked. Each participating company studied was given ten questionnaires to distribute through a stratified random-sampling procedure which ensured the inclusion of male and female participants, experienced and less experienced workers, and middle management as well as nonmanagement personnel. Of the 180 questionnaires administered, 100 were returned, representing a response rate of 55.6 percent. Of these, 98 were considered valid for inclusion in the study.

A thirty-item questionnaire was developed. Respondents were asked to indicate, using a four-point Likert-type scale (1 = strongly disagree, 4 = strongly agree), the degree to which they disagreed or agreed with a particular statement. The questionnaire was designed to measure three variables: loyalty, motivation, and morale. Each variable was measured on a ten-item scale.

Loyalty was measured in terms of Scherhorn's formulation about employees' commitment to the organization. According to Scherhorn, "an individual who has high organizational commitment is considered very loyal."²² Thus, in this study, the loyalty scale included features such as commitment to organizational goals, willingness to defend company policies, long-term employment commitment to the company on the part of the employee, and having a sense of belonging in the company.

Morale was measured in terms of the degree

to which employees' needs are satisfied by the organization, employees' willingness to take risks, acceptance of innovation, creative thinking, and employee perceptions on whether the company was fair and caring. This is in agreement with current thinking in the literature. According to Certo "common signs of low morale in a company are workers who seldom initiate new ideas, go out of their way to avoid tough situations, and strongly resist innovation."²³ Similarly, Rachman et al. have suggested that some of the positive conditions that could contribute to high morale include fairness in dealing with employees, clarity of organizational goals, appreciation of employees, and responsiveness to employee needs.²⁴

In measuring motivational strategies, the study considered the perception of employees regarding motivational strategies that have been found to be effective in today's global economy. These include training and retraining, behavior modification, flexible schedules (flextime), job design, job sharing, monetary incentives, and telecommuting.²⁵ Thus, in this study, motivation was measured in terms of the employees' perception regarding the degree to which traditional and nontraditional motivational techniques were utilized by the various companies.

Internal consistencies of the scales as measured by Cronbach's alpha were found to be quite high in all three subscales (alpha = 0.91, 0.89, and 0.93 respectively).

Follow-up interviews were also conducted to elicit information on specific organizational problems and motivational techniques being used in the organizations. Respondents' ages ranged from twenty to forty-four years and 79 percent of the sample were female. Forty-nine percent of the sample classified themselves as either clerical or technical staff, while 32 percent classified themselves as nonmanagerial salaried; 10 percent were lower-level managers; and 9 percent were middle-level managers.

Statistical Tests Results

Each respondent's scores were summed and the means for each variable computed. The scores were then converted into z-scores so that each subject could be categorized in terms of a standardized score on the relevant variables.

Respondents were categorized as high or low on a variable based on whether their score was above the mean of 50 (high) or below 50 (low). This enabled the researchers to recognize two categories of subjects on each of the variables that form the basis of this study: high loyalty–low loyalty; high motivation–low motivation; and high morale–low morale. Where necessary, hypotheses were formulated to test the significance of the relationships between the variables examined. Appropriate statistical tests (χ^2 , Pearson's r , and t -test of significance) were applied to test the hypotheses formulated in relation to the research questions. Chi square tests were used to determine if gender, level of experience, and occupational type were significantly related to employee loyalty. The Pearson's r was also used to determine if there was a significant correlation between employee motivation and loyalty.

Research Question 1: How Loyal Are the Employees of the Selected Companies?

In answering this research question, the responses to ten items dealing with such issues as willingness of the employee to remain in the company or leave if a more financially rewarding job was found were used to measure the respondent's level of loyalty. The items were scored and converted to z -scores (or standardized) in order to classify the subjects as high-loyalty or low-loyalty employees. The results are summarized in Exhibit 2.

Exhibit 2		
Employee Loyalty		
	Number	Percent
High loyalty	58	59
Low loyalty	40	41
Total	98	100

The exhibit shows that, 59 percent of the respondents were considered to have high loyalty, while 41 percent had low loyalty. This finding differs greatly from those in earlier studies such as the 1993 Moskal survey which indicated that 77 percent of the employees studied were not loyal.²⁶ While the case could be made

that the samples used in these studies vary in several respects, it is necessary to note that attitudes towards management in any downsizing exercise are likely to be very similar. What has changed, and what could account for the difference between the finding in this study and previous ones may have to do with such factors as more education about the rationale for downsizing, better organizational communication methods, and an improvement in the mobility prospects of individual employees.

Some of the questionnaire items addressed employee grievances as well as the changing position on loyalty to the organization. For example, 60 percent of the subjects either strongly agreed or agreed with the statement, "I will not hesitate to quit this company even if the job I find does not have a higher pay." This indicates a serious lack of commitment to the present organization and a general dissatisfaction with the status quo. Loyalty cannot be a serious issue for an employee in such a situation. Another item which dealt with employee loyalty sought the worker's degree of agreement with the statement, "In this age of downsizing, loyalty to a company is a thing of the past." Again, the response was overwhelmingly unfavorable as 63 percent of the subjects either agreed or strongly agreed with the statement.

In general, the analysis of responses to items designed to measure the level of loyalty indicates that while most of the subjects could still be grouped under the "high loyalty" category, a substantial number are not too interested in being loyal any more. If, as some scholars have stated, loyalty is "the glue" that holds the organization together,²⁷ management will need to take measures to address issues that have led to a reduction in loyalty among employees. No organization can survive the fierce competition in the global market that has led to downsizing in the first place if employees are demoralized and not overtly loyal.

Research Question 2: To What Extent Do Such Variables as Gender, Experience (Length of Service), and Occupation Type Affect the Level of Employee Loyalty?

In answering this question, it was hypothesized that there would be no significant relationship between gender and the level of employee loyalty,

between experience and the level of loyalty, and between occupational type and the level of loyalty. Exhibit 3 summarizes the results.

The results as presented in this exhibit indicate that the proportion of male subjects who have high loyalty (71%) was not significantly greater than the proportion of female subjects who have high loyalty (56%), ($\chi^2 = 2.24$; $p > .05$). There is no evidence to suggest that a particular gender was favored in the matter of downsizing. It is, therefore, not surprising that the level of employee loyalty is not significantly affected by gender.

to five years are classified as "inexperienced" A closer look at those classified as experienced employees reveals that 57 percent have high loyalty, while 61 percent of those classified as inexperienced employees have high loyalty.

Under normal circumstances the longer one remains in a company, the more loyal one is expected to be. However, since length of service (experience) did not appear to be an important consideration in the decision to downsize, the idea of loyalty growing proportionately with experience does not appear to hold true anymore.

Exhibit 3					
Level of Loyalty by Gender, Experience, and Occupation					
	High Loyalty Number/Percent		Low Loyalty Number/Percent		Total Number
Gender					
Male	15	15.3	6	6.1	21
Female	43	43.9	34	34.7	77
$\chi^2 = 2.24^a$					
Experience					
Experienced	25	25.5	19	19.4	44
Inexperienced	33	33.7	21	21.4	54
$\chi^2 = 0.17^a$					
Occupation Type					
Manager	6	6.1	3	3.1	9
Supervisor	4	4.1	6	6.1	10
Clerical	24	24.5	24	24.5	48
Other (Technical)	24	24.5	7	7.1	31
$\chi^2 = 7.815^b$					
Note: a. $p < .05$. b. $p < .05$.					

Similarly, there was no significant relationship between experience and the level of loyalty ($\chi^2 = .17$; $p > .05$). About 57 percent of those employees who have not spent up to five years with the company have high loyalty, whereas 43 percent of those who have spent five or more years have high loyalty. It is important to note that employees who have spent up to five years in the company are classified as "experienced" while those who have not spent up

On the question of the relationship between occupational type and loyalty, there appeared to be a significant relationship ($\chi^2 = 7.815$; $p < .05$). This finding confirms the observation in the literature that companies are careful about the kinds of positions they eliminate. Generally, technical staff, especially those in the chemical industry, are rarely downsized. Workers in this category are less likely to lose their jobs through downsizing than other workers in less specialized

areas.²⁸ If this assumption is true, then this class of workers would enjoy a higher degree of job security. The fact that a substantial part of the sample studied consists of technical personnel would account for the significant relationship found between occupational type and level of loyalty.

Research Question 3: How Has Downsizing Affected the Level of Morale of Employees in Selected Companies?

The study found that about 41 percent of the respondents had a high level of morale while the majority (59%) had low morale. A further breakdown indicated that 40 percent of female subjects and 43 percent of male subjects had high morale, while 60 percent of the females and 57 percent of the males had low morale. The results are presented in Exhibit 4.

Exhibit 4				
Level of Morale of Subjects by Gender				
	High Morale		Low Morale	
	Number	Percent	Number	Percent
Male	9	43	12	57
Female	31	40	46	60
Total	40		58	

As the exhibit indicates, there is very little difference between the level of morale of male and female employees. This is not surprising, considering that the job environment for both sexes is identical and downsizing does not appear to be based on gender considerations. What may be considered surprising is that the number of people with low morale is not even higher. Perhaps management has started to take the issue of boosting morale more seriously in the wake of the overwhelmingly negative reaction to downsizing.

The findings on this question lend support to the predominant view which suggests that downsizing has adversely affected the morale of employees.²⁹ However, this study also supports the findings reported in McDonald to the effect that "the American worker is amazingly resilient."³⁰ McDonald reports that the attitudes of 3,300 workers studied "reveal they want their

companies to succeed—and they want to be part of the process that makes that happen."

The fact that management has continued to pay for benefit programs designed to improve the work environment generally may be seen as an acknowledgment by management that something drastic would have to be done to offset the employees' negative feelings. While management may expect survivors of downsizing to feel that the company has enough confidence in them to retain them, survivors have a less flattering opinion of the situation. Survivors still operate in a climate of fear, having witnessed the sudden departure of their peers and superiors. Perhaps management is gradually coming to realize that the breach of the psychological contract between employee and employer would seriously jeopardize the survivors' morale. Thus, management had to target benefit programs to boost morale.

New programs designed to increase morale may have had some effect. This conclusion is supported by responses to some of the questionnaire items. For example, most subjects strongly disagreed with the statement that suggested they lived in constant fear of losing their job as a result of downsizing (15%). But at the same time there appears to be a high level of uniformity in their strong agreement with the statement that suggests their company has not been as fair and caring toward its employees as it had been in the past (31%). Morale appears to be low but not as low as to make employees live in constant fear of losing their job. If employees are too concerned about job security, they will be less willing to think creatively and to take risks. This insecurity can lead to lower motivation and threaten organizational productivity. According to Maslow's hierarchy of needs,³¹ employees who worry about employment prospects are not likely to be motivated, creative, or productive. Their behavior will be influenced by persistent attempts to satisfy their safety and security needs. Thus, organizations will have to find ways of supporting and encouraging creativity and risk taking.

Research Question 4: To What Extent Has Management Succeeded in Motivating Employees by the Range of Innovative Benefit Programs Introduced by the Company?

The companies have introduced new programs designed to motivate employees in this era of downsizing. What is not so clear is whether these programs are achieving the desired effect. According to this study, only 57 percent of the employees are highly motivated. A closer look at the data reveals that 43 percent of the male subjects and 45 percent of the female subjects are highly motivated. In general, workers do not appear to have been positively affected by benefit programs; at least they had not attained the level of motivation desired by their companies.

The reasons for the low level of motivation are not difficult to understand. For example, only 25 percent of the subjects agreed that they had regular access to on-the-job training to enhance their performance (item 13). Companies also scored low on the availability of popular programs like healthcare, daycare, and elderly care. Only 42 percent agreed that they had sufficient access to at least two such programs even though all of the subjects agreed that these programs would be desirable. Finally, only 36 percent either agreed or strongly agreed with the statement, "My company has adequate training programs to develop, advise, and redirect workers." In short, while companies may claim to promote motivational programs, most employees do not agree that the programs are appropriate, adequate, effective, or even available. This finding also strengthens the popular belief that the loss of job security can lead to a situation where the company is stuck with a workforce that is not only unmotivated but is also demoralized.³²

One of the problems related to motivation has to do with the fact that many companies wrongly assume that traditional strategies could be sufficient to motivate workers in an environment where employee loyalty has been negatively affected by downsizing. It would be a mistake to assume that since a traditional motivational technique such as a bonus is related to loyalty, all that is needed to solve the problem of declining loyalty is to increase the amount of the bonus offered.

This study found that an increase in the motivational technique would not necessarily result in increased loyalty unless that motivator is high on the employees' priority list of needs. With restructuring, it is only reasonable to assume that some traditional motivational techniques may become outdated in terms of their usefulness.

Some nontraditional motivational techniques that are more relevant to the needs of employees who live in fear of losing their jobs have to be employed if an acceptable level of loyalty is to be attained.

A comparison of the relative importance of selected traditional and nontraditional motivational techniques indicated some major differences between techniques used by employers and those desired by employees.

As Exhibit 5 shows, bonus is ranked equally high by employers (1) and employees (2). But while employees consider training and retraining as the most desired motivator, employers rank training fifth in importance. Similarly, while profit sharing is rated highly by employers (ranked second), it is not considered very desirable by employees who ranked it sixth. A nontraditional motivational technique like flexible scheduling appears to be important to employees but it is apparently unimportant to employers. Not all nontraditional motivational techniques are rated low by employers. For example, job sharing was rated fourth by employers but only ninth by employees.

Research Question 5: Is There a Significant Correlation Between Employee Motivation and Loyalty?

In order to answer this question, it was hypothesized that there would be no significant correlation between employee motivation and loyalty.

The Pearson Product Moment correlation was computed and the t-test of significance was applied to the correlation coefficient obtained. The result indicated that the computed correlation coefficient ($r = .58$, $p < .05$) was significant. Thus, there is a significant relationship between motivation and loyalty. The hypothesis was, therefore, rejected.

The study subjects have experienced firsthand what may be described as a disloyal behavior on the part of management. It is only to be expected that they would not be highly motivated, even with the tremendous effort at motivation by management. Perhaps it is too soon to expect motivational efforts and other incentives by management to have reversed the downward trend in loyalty and motivation. However, as companies actively seek loyalty through more

relevant employee-oriented programs, employees may feel obliged to restore some degree of loyalty lost through downsizing.

Loyalty is being redefined by employees as they renegotiate the psychological contract with their employers.³³ Job security will be an important part of this new reality because of current trends in global economic practices, as well as the new orientation of the corporate world regarding issues such as efficiency, profitability, and shareholders' interests. At the same time, downsizing does not necessarily eliminate loyalty in the long run. This study highlights management's awareness of the continued importance of loyalty in organizations. However, whether the benefit programs introduced by the companies will be adequate to sustain loyalty for a long time is debatable.

Exhibit 5
Rank Order of Employer-Employee
Preferences of Motivational Techniques

Motivational Techniques	Used By Employers	Desired By Employees
Training and retraining	5	1
Flexible schedules (flextime)	7	4
Quality of Work Life (QWL)	6	7
Telecommuting	10	10
Noncash rewards (e.g., employee discount, etc.)	3	3
Satisfying work	8	8
Life-balance programs (e.g., daycare, elderly care)	9	5
Job sharing	4	9
Profit sharing	2	6
Bonuses	1	2

Conclusions

It is evident that management and employees will have to work harder to meet the goals of the organization without disregarding the basic needs of the individual for some kind of job security. Perhaps job security would have to be seen from another perspective—the perspective of providing adequate training for the employees so that they can be employable in case of downsizing. Obviously, a drastic revision of the psychological contract between the employer and the employee

is needed if the difficult task of meeting management's goals while at the same time taking care of the employee's professional needs is to be accomplished. Companies do not have to abandon their employees when they downsize. They can even profit from looking out for their employees. As Matthes points out, they can place former employees in new jobs or relocate some in positions elsewhere in the organization or in positions with affiliated organizations.³⁴ It is also possible to assist some employees through career transition training, job fairs, and retraining.

In handling the issue of motivation through innovative benefit programs, the following guidelines are suggested: Nontraditional motivational strategies may be very useful to reestablish loyalty. For example, training geared toward acquiring new skills (making employees more employable elsewhere) and flexible schedules may be very useful. However, not all nontraditional motivational strategies will be relevant in all situations.

Traditional motivational strategies are still useful provided management establishes through research that they are relevant with respect to the particular set of employees. This study indicates that profit sharing, job sharing, life-balance programs, and telecommuting are not considered particularly important as motivators by employees, regardless of what employers believe. Finally, the need for a more effective organizational communication cannot be over-emphasized especially during a period of restructuring. In the present study, only 45 percent of the respondents agreed with the statement that their companies "readily shared relevant information about the company's future" with them. Obviously, keeping employees in the dark about an organization's future plans can be disruptive to employee performance. Open communication during downsizing or restructuring can keep rumors from getting out of control, improve morale, and allow employees to concentrate on improving performance in the organization. These findings highlight the need for better communication between employers and employees so that employers would know what employees consider important.

Employees should have an input in the implementation of some of the motivational techniques. Retraining and flexible scheduling could be considered in positive terms only if the

employee finds the training relevant and the flextime convenient. For example, follow-up interviews indicate that employees felt that the type of training provided by employers was aimed at enabling workers to take on more duties as a result of staff shortage due to downsizing. This is in stark contrast to employee expectation, which is to receive training that would make them more employable elsewhere in case of downsizing. This example highlights the type of communication problem that could negatively affect the effectiveness of any motivational technique.

A sign of improved organizational communication is the awareness on the part of employees that more benefit programs are being established for employees, thus ensuring that opportunities for personal growth are still available within the company. However, understanding the rationale for downsizing would not necessarily translate into unconditional loyalty as the findings on this research question show. In view of the disruptive effect of downsizing on employees in general as well as the much publicized position of employers regarding the virtual abolition of the clause on job security in the psychological contract, it is not surprising that less than two-thirds of the employees in this study were found to have a high degree of loyalty.

When we consider the fact that employee loyalty used to be taken for granted before the era of downsizing, the findings here indicate that the serious attention that management is beginning to pay to the issue of loyalty is fully justified. Obviously, it was not a conscious decision by management to trade profitability for reduced employee loyalty; but loss of loyalty has become an unintended consequence that management is

learning to deal with.

If companies are to replace the perception of downsizing as a strategy used by mean-spirited executives to get rid of loyal employees with a more positive image of downsizing as a necessary strategy that could be of mutual benefit to employers and employees, they will need to go beyond traditional incentives. Employers will need to focus on specific needs of their employees in determining the particular mix of traditional incentives and nontraditional motivational strategies to be employed to motivate their employees to attain organizational goals in this era of downsizing.

Downsizing as a management strategy may not have achieved all it was designed to,³⁵ but it has made employees aware of the need to move away from the old practice of complacency which often leads to decline in productivity. No longer would people feel assured of a lifetime of employment with one single company. This realization has served as an incentive for risk taking and creativity on the part of employees who now strive to articulate their contribution as well as their continued relevance within the organization.

Companies that provide challenging and satisfying work can still expect a new form of commitment from their workers. Understanding the dynamics of teams will be crucial to the competitiveness of the organization in the future. Even though some employees feel no loyalty to management, they are willing to work hard to help their coworkers, if only for the motivation and support they obtain from such coworkers in times of downsizing, reengineering, or restructuring.

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NEJE

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Value Creation in New Firms: Evidence from the Biotechnology Industry¹

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The purpose of this study is to empirically examine those factors that enhance the value of newly public firms. The article presents a model for the market value of a newly public biotechnology firm. Explanatory variables include several intangible indicators of the scientific capabilities of the firm including firm citations, licenses, patents, products in the pipeline, and R&D intensity. Top management team variables are also examined. The results support the conclusion that scientific capabilities significantly impact the value of the firm as viewed by public equity markets.

Recent research has examined both initial public offerings (IPOs) of stock² as well as post-IPO performance.³ One specific characteristic of IPOs, namely underpricing, has been extensively examined⁴ yet still offers researchers conflicting results. Underpricing simply refers to the price a firm goes public with and the prevailing market price in the immediate after market.⁵ One topic which is lacking in the literature on IPOs is what specific factors are valued by public equity markets. To help answer this question, this article offers a model of new-firm valuation based on firm intangible assets, in particular scientific capabilities, and top management team factors.

The research of intangible resources has generally focused either on the perceived value of intangible resources by company CEOs,⁶ their value in building competitive advantage,⁷ or their role in the internationalization process.⁸ In measuring intangible resources, researchers have tended to use proxies for each intangible asset such as advertising intensity, R&D intensity,⁹ and legal intensity¹⁰ without considering how these assets may directly impact the market value of the firm.

This article seeks to expand the literature stream in two ways. First, the market value of newly public biotechnology firms is used as a proxy for the value of the firm's intangible resources. These newly public firms have few, if

any, products and little or no income to help the market in firm valuation, thus the firm's value is held almost totally in the form of intangible resources. Second, this article empirically shows how the market values an initial stock of intangible resources.

Small, high-technology companies face, as a major hurdle to their growth and development, the acquisition of capital. Organizations dependent on long, expensive, and risky development projects find the acquisition of capital to be particularly difficult. This may be due to the fact that information asymmetries between investors and entrepreneurs are extremely pronounced when the entrepreneurial endeavor is highly technical and depends on cutting-edge scientific research for its success.

Firms that base their growth and development on cutting-edge scientific research pose significant problems for the market because investors largely do not have the specific knowledge necessary to evaluate the scientific capabilities of the organization and the probability of the organization successfully commercializing their basic research.¹¹ These organizations depend almost totally on their proprietary knowledge and are therefore unlikely to provide information detailed enough about their research to allow investors to accurately evaluate the organization's chances for success. These firms are trapped in Arrow's paradox.¹² To properly evaluate an organization's initial public offering, investors require detailed information about the company's proprietary research, but if the firm discloses this information they increase the risk of their proprietary knowledge being transferred to competitors. Without this disclosure, however, investors are unable to accurately assess the organization's market potential.

To overcome these information asymmetries, entrepreneurs may send signals to potential investors which are meant to accurately represent the quality of the organization. Investors may use

a number of observable characteristics (earnings, size, market share, total assets, etc.) as well as entrepreneurs' signals to evaluate organizations entering the equity market. However, since it is in the best interest of the entrepreneur to highlight the strengths and obscure the organization's weaknesses, the entrepreneur must send signals which investors can observe and believe to be credible. Spence argued that such credibility arises when the signal imposes nontrivial costs on the entrepreneur sending the signal.¹³ These costs indicate that the entrepreneur expects future benefits from the signal to exceed the signal's current costs.

During the previous decade entrepreneurs in biotechnology firms have confronted the problem of asymmetrical information. Burrill and Lee report that 225 new biotechnology firms have raised capital using IPOs.¹⁴ In most cases, these biotechnology firms have been young, small organizations which are undertaking highly uncertain projects dependent on the commercialization of recent scientific discoveries.¹⁵ Most of the organizations are years away from any significant revenue stream and have no assets other than their scientific capabilities.¹⁶

To succeed, these organizations must accurately evaluate the commercial potential of a recent scientific discovery and possess the skills and knowledge necessary to move this discovery through the development process. The organization's ability to complete this task depends on its scientific knowledge, its access to additional relevant knowledge, and the skills of its top management team, in other words its intangible resources.

In essence, the value of the equity of these organizations depends on their intangible resources. The problem facing entrepreneurs in biotechnology has been how to overcome these information asymmetries and signal the strength of their intangible resources. This study focuses on two broad categories of intangible resources which can help investors overcome information asymmetries: top management team characteristics and scientific knowledge.

This article presents a literature review and hypotheses. It discusses the data and methodologies and analyzes the results. Finally, it offers a summary and concluding remarks.

Literature Review and Hypotheses

Intangible resources may be defined as "nonphysical assets whose values are difficult to define and measure, yet appear to play a major role in competitiveness."¹⁷ Intangible assets include patents, trademarks, copyrights and registered designs, trade secrets, contracts and licenses, databases, information in the public domain, personal and organizational networks, employee know-how, reputation, organizational culture,¹⁸ management,¹⁹ R&D, and software.²⁰

In general, an intangible asset is any attribute a firm's rivals cannot quickly or effectively imitate.²¹ The research of intangible resources has generally focused either on the perceived value of intangible resources by company CEOs,²² their value in building competitive advantage,²³ or their role in the internationalization process.²⁴ Accountants have difficulty among themselves when trying to determine the correct accounting technique for valuing intangible resources. In this study, the value of intangible assets manifests itself in the market value of the firm.

Citation Analysis

New product development in high-technology environments is increasingly being driven by basic scientific research.²⁵ This makes the quality of a biotechnology firm's scientific team critical to the product development process. One part of this scientific team is the Scientific Advisory Board. This group consists of a number of individuals with extensive backgrounds in fields such as immunology, virology, and microbiology. These individuals act as consultants to the firm's management. One signal a biotechnology firm can give to potential investors is the quality of its Scientific Advisory Board. One measure of this quality is citation analysis.

Citation analysis uses the number of times a paper or an author is cited as an indication of the importance of the work to the field. The more frequently the paper or an individual's body of work is cited the more important, and hence, the higher the quality of work. In recent years, citation analysis has been used to map the development of science,²⁶ to estimate the quality

of the scientific capabilities of countries in specific fields,²⁷ the performance of academic depart-

ments,²⁸ and as the basis for the assessment of scientific and technical research programs.²⁹

In addition, citation analysis has recently entered into the discussion of strategic planning. Ven Der Eerden and Saelens discussed the use of citations as indicators of research group performance and the quality of the scientific research being undertaken by the group, as well as a tool to guide competitive assessment, mergers and acquisitions, targeting, and research strategy.³⁰

H1: The number of times Scientific Advisory Board members have been cited previous to the IPO will be positively related to firm market value.

Contracts and Licenses

According to Hall, contracts, which may be in any number of forms (agency agreements, license agreements, property leases), are considered one of the most important intangible resources for some businesses.³¹ Contracts exist to regulate business and economic relationships.³² Contracts then define the terms of agreement so that each party to the contract can protect and enforce their rights. Parties to a contract, however, cannot foresee all possible future contingencies which adds a dimension of risk to the contract.³³ In the case of biotechnology companies, contracts typically cover one of three areas: R&D alliances, marketing alliances, and, more rarely, production agreements. These external linkages provide an important source of new ideas to new firms.³⁴ Recent research has also documented a positive relationship between the number of firm alliances and the research productivity of the firm.³⁵ Assuming access to new ideas and increased research productivity is important to new firms.

H2: The number of contracts held by the firm at the time of the IPO will be positively associated with market value.

Patents

Patents have been associated with innovation and performance at many levels including company, region, and country. Patents are considered indicators of important technology positions and

innovative activity³⁶ and can be considered inputs in the new product development process.³⁷ A positive relationship between patents and firm market value has been reported by a number of researchers.³⁸ Whether patents are a precursor to entering a product into trials, an important input into the development process, or an early stage in a process that leads to invention through development, testing, and engineering,³⁹ they will be positively related to the value of an entrepreneurial high-technology firm.

H3: The number of patents held by the firm at the time of the IPO will be positively related to firm market value.

Total Products in the Pipeline

A common indicator of technological competence or expertise in the pharmaceutical industry is the number of drugs in development or in the "pipeline." Financial analysts and potential investors monitor the products being pursued⁴⁰ because in industries populated by high-technology firms success may be measured by the rate at which the firm develops new products.⁴¹ Rapid development of new products and their marketing is important in gaining external visibility and legitimacy, gaining early market share and increasing the likelihood of survival.⁴² The strength of a firm's pipeline is also considered an important indicator of a company's future cash flow although the exact value of any product in the pipeline is unknown.⁴³ The amount and type of new drugs in a company's research pipeline reveals to the financial markets the future potential value of the company's current scientific capabilities.

H4: The number of new drugs in a firm's pipeline will be positively related to the firm's market value.

R&D Expenditures

More important to this discussion, however, is the relationship between R&D expenditures and market value. This relationship has consistently been found to be significant and positive⁴⁴ especially so for high-technology firms.⁴⁵ Several

studies have also investigated the relationship between R&D expenditures and productivity returns.⁴⁶ These results are to be expected given that management sets the R&D budget to maximize the discounted value of the firm's expected future cash flows and that the stock market measures the company's expectations subject to measurement error.

H5: The total R&D expenditures by firms in the last five years prior to their IPO will be positively related to their market value.

Top Management Teams

The study of top management teams are based largely on the works of Hambrick and his colleagues.⁴⁷ Top management team characteristics have been investigated as determinants of high-technology venture success,⁴⁸ innovation,⁴⁹ strategic change,⁵⁰ and corporate performance,⁵¹ among others. This article seeks to link the firm's top management team with its market value. Three variables, in particular, should reflect the market value of management in newly public high-technology firms: education, the completeness of the top management team, and experience.

Education

An individual's education level reflects their cognitive ability and skills.⁵² High education levels are associated with higher levels of information processing capacity and the ability to discriminate among a variety of stimuli.⁵³ Additionally, high levels of education have been associated with innovation receptivity.⁵⁴ These characteristics are especially important for the top management teams of biotechnology companies.

Top management team members may be among only a handful of people in the world with the necessary expertise to understand the scientific discoveries their firms are attempting to commercialize. Top management team members holding a Ph.D. in a technical area are recognized as likely having the expertise necessary to develop their firm's discoveries.

H6: There is a positive relationship between the percentage of the top management team holding a Ph.D. and firm market value.

Top Management Team Completeness

One under investigated feature of top management teams is the completeness of the team. A complete top management team includes a president and executives responsible for marketing, engineering, finance, and operations.⁵⁵ Due to the specialized nature of biotechnology firms, this list has been slightly amended to include an executive responsible for research and development in place of engineering. We also assume all firms have a president. Investigating technological start-ups, Roure and Maidique found that successful start-ups had teams either 100 or 80 percent complete teams while unsuccessful companies had teams ranging from 80 to 50 percent complete.⁵⁶ Given that companies with higher degrees of top management team completeness appear to be more successful and that the market rewards success:

H7: The degree of completeness of the top management team will be positively associated with the market value of newly public biotechnology firms.

Top Management Team Experience

A manager's previous experience in an industry has been argued to be a predictor of successful entrepreneurs.⁵⁷ Siegel, Siegel and MacMillan found industry experience to be positively related to the success of high-growth ventures,⁵⁸ while Roure and Maidique⁵⁹ found industry experience to be positively related to the success of high-technology ventures.

H8: The percentage of the top management team with experience in the biotechnology or pharmaceutical industry will be positively related to market value.

Data and Methodology

This section describes a study of intangible resources in biotechnology firms.

The Sample and Data

The biotechnology industry of 225 publicly held companies provides the population of firms for this investigation.⁶⁰ These firms were contacted by

phone with a request for a copy of the prospectus from their IPO. A total of 106 companies provided a prospectus representing a response rate of 47 percent. However, 5 of these companies were excluded from the sample because of incomplete data. Thus, the final sample consisted of 101 companies.

To test for potential biases in this sample, the average total assets and average total liabilities of the firms in the sample in 1992 were compared to the average total assets and average total liabilities reported by Burrill and Lee⁶¹ for all 225 public firms. The sample averaged \$11,123,000 in total assets and \$3,515,000 in total liabilities. Burrill and Lee reported the average total assets and total liabilities of the 225 public biotechnology firms in 1992 as \$11,377,00 and \$3,313,000 respectively. In addition, the percentage of nonpharmaceutical health care companies in the sample was 15 percent and the industry-wide percentage, as reported by Burrill and Lee was 17 percent.⁶² Based on these comparisons and the size of the sample, we believe the sample is fairly representative of the publicly held biotechnology companies.

The data in the sample was gathered from (1) the prospectus from each of the IPOs by the firms in the sample, (2) the Science Citation Index and, (3) the Center for Research in Security Prices (CRSP) tapes.

Dependent Variables

The dependent variables in the study are the total market value of the offering firm's equity at the end of the first day (DAY), first week (WEEK), and first month (MONTH) of trading (\$ 1990). The market value at the end of the first day and week of trading were used to present the market's initial reaction to the IPO. The market value of the firm at the end of the first month of operations was used to present how the market values an initial set of intangible assets after having had time to more closely examine the firm.

Independent Variables

This study used citation data as an indication of the quality of the scientific personnel of the biotechnology firm (CITATION). Names of the firm's top scientists listed in the prospectus were compiled. The Science Citation Index was used to gather the total number of citations for each scientist during his or her career. These citations

were then totaled to create a measure of the quality of the scientific team employed by the biotechnology firm at the time of its IPO. Due to a skewed distribution, the total number of citations was transformed using a logarithmic transformation.

From the offering firm's prospectus, a count of the number of contracts and licenses (excluding sole licenses for patents) was obtained (CONTRAC). Licenses for the sole use of patents was included in the patent variable.

From the offering firm's prospectus, a count of the total number of patents held by that firm was obtained (PATENT). This includes both patents granted directly to the firm and patents in which the firm is the sole licensee. Patents which have been licensed are included here rather than under contracts/licenses because, as sole licensee, the firm has exclusive rights to the knowledge content of the patent as if the patent were directly granted.

In the business section of each prospectus, companies report the number of products under development or which have reached the market (PRODS). Only products that had reached the preclinical stage of development or beyond were included. Multiple applications of the same product were counted as a single product.

The measure of total research and development expenditures was defined as the total R&D spending divided by total expenditures in the year previous to the IPO (R&D). A logarithmic transformation was used to control for the skewness of the distribution.

The education level of the top management team was coded as a percentage of the members with a Ph.D. (EDUCAT).

The experience of the top management team was coded as the percentage of the members with experience in the biotechnology or pharmaceutical industries (EXP).

Finally, the completeness of the top management team was measured as the percentage of members of the top management team (as defined previously) each firm employed (TMTCOMP). All of the top management team data was collected from the prospectus for each firm's IPO.

Control Variables

The total assets of the offering firm prior to the IPO was used to control for the influence of size on market value (ASSET). A logarithmic transformation was used to control the skewness of the distribution.

It has been well documented⁶³ that the market for IPOs experiences periods in which the value of firms going public is substantially higher. The years 1983, 1986, 1991, and 1992 were hot markets for biotechnology IPOs. Therefore, to control for the effects of the hot market on firm value a dummy variable was included in the model (HOT). Those firms which made offerings during hot years were coded as "1" and all other firms were coded as "0."

Results

The data were analyzed using ordinary least squares regression. Descriptive statistics of the variables and the correlation matrices are presented in Exhibits 1, 2, and 3.

Exhibit 4 presents the regression analyses with the various market values of the firm as the dependent variables. Three different models were run corresponding to the firm's market value at the end of the first day, week, and month of trading. All three models are significant at the .001 level (model 1 F-statistic = 7.85, model 2 F-statistic = 7.61, model 3 F-statistic = 8.30).

These statistics indicate the model is explaining a significant amount of the variation in the market value of firms.

In each of the three models, the total number of products in the pipeline and the firm's R&D intensity were significant thus supporting hypotheses four and five. In model three, patents and the completeness of the top management team were significant, thus giving partial support for hypotheses three and seven. Hypotheses one, two, six, and eight were not supported.

Discussion

From the entrepreneur's perspective, the purpose of this article has been to present how the market value of biotechnology firms can be enhanced. Effective managers can use this study's results to gain insight into what resources are highly valued

in equity markets and can then increase the value of their firm by accumulating these resources (when relevant to their specific firm, industry, etc.), especially when the firm is preparing its IPO of stock.

Ambiguity concerning the research potential and future profitability of biotechnology firms poses significant informational obstacle for financial markets. This forces biotechnology firms and investors to rely on credible signals to communicate the value of the firm.

The results of this study support the hypothesized relationship between firm market value and four of the hypotheses (patents, R&D intensity, total products in the pipeline, and completeness of the top management team). Although the results for the hypotheses are somewhat tenuous, this is not surprising given the general lack of explicit knowledge concerning individual biopharmaceutical products among investors. The most highly significant variables—firm assets and hot market—are very easy for investors to interpret. The remaining significant variables—patents, R&D intensity, products in the pipeline, and TMT completeness—are either minimally significant or appear as significant only after a month of trading. This suggests that investors are unclear as to what factors may lead to future success in this industry. Given some time, investors are more able to evaluate the newly public biotechnology firms and are able to be gin the process of determining what intangible factors may lead to future success. This clearly demonstrates that given time, investors in biotechnology firms come to believe that several indicators of firm scientific capabilities are signals of the future value of the firm.

A major implication of the results is the importance of the credibility of the signal being sent by the firm to investors. Each of the significant predictors can be verified by potential investors although some are more difficult to interpret than others. All of the variables related to the scientific capabilities of the firm, except firm citations, were significant in the third model. This suggests that the market needs some time to put a value on the firm's scientific capabilities. Firm citations may not reflect a true measure of

Exhibit 1
Correlation Matrix—Model 1

	mean	s.d.	1	2	3	4	5	6	7	8	9	10	11
1. DAY	95209	77189	1.00										
2. EDUCAT	.48	.20	.11	1.00									
3. TMTCOMP	.61	.23	.21 ^b	-.08	1.00								
4. HOT	.79	.41	.32 ^d	-.04	.08	1.00							
5. R&D	.60	.23	.40 ^d	.41 ^d	.04	.10	1.00						
6. CITATION	139.37	196.91	.21 ^b	.19 ^b	-.04	.09	.22 ^b	1.00					
7. ASSET	10323397	10069583	.55 ^d	.11	.28 ^c	.03	.25 ^c	.15 ^a	1.00				
8. PRODS	3.30	4.26	.30 ^c	.16 ^a	.17 ^a	.02	.35 ^d	.11	.08	1.00			
9. EXP	.70	.22	-.01	-.14 ^a	.16 ^a	-.03	-.01	-.00	-.04	.05	1.00		
10. PATENT	3.30	4.85	.02	-.06	.15 ^a	.06	.09	-.00	-.07	.41 ^d	.05	1.00	
11. CONTRAC	4.97	4.15	.16 ^a	.17 ^a	.12	.02	.35 ^c	.50 ^c	.15 ^a	.08	.03	-.04	1.00

a. $p < .10$. b. $p < .05$. c. $p < .01$. d. $p < .001$.

Exhibit 2
Correlation Matrix—Model 2

	mean	s.d.	1	2	3	4	5	6	7	8	9	10	11
1. WEEK	92888	76594	1.00										
2. EDUCAT	.48	.20	.12	1.00									
3. TMTCOMP	.61	.23	.22 ^b	-.08	1.00								
4. HOT	.79	.41	.30 ^c	-.04	.08	1.00							
5. R&D	.60	.23	.40 ^d	.41 ^c	.04	.10	1.00						
6. CITATION	139.37	196.91	.21 ^b	.19 ^b	-.04	.09	.22 ^b	1.00					
7. ASSET	10323397	10069583	.55 ^d	.11	.28 ^c	.03	.25 ^c	.15 ^a	1.00				
8. PRODS	3.30	4.26	.29 ^c	.16 ^a	.17 ^a	.02	.35 ^d	.11	.08	1.00			
9. EXP	.70	.22	-.03	-.14 ^a	.16 ^a	-.03	-.01	-.00	-.04	.05	1.00		
10. PATENT	3.30	4.85	-.01	-.06	.15 ^a	.06	.09	-.00	-.07	.41 ^d	.05	1.00	
11. CONTRAC	4.97	4.15	.15 ^a	.17 ^a	.12	.02	.35 ^d	.50 ^d	.15 ^a	.08	.03	-.04	1.00

a. $p < .10$. b. $p < .05$. c. $p < .01$. d. $p < .001$.

Exhibit 3
Correlation Matrix—Model 3

	mean	s.d.	1	2	3	4	5	6	7	8	9	10	11
1. MONTH	93458	70134	1.00										
2. EDUCAT	.48	.20	.17 ^a	1.00									
3. TMTCOMP	.61	.23	.30 ^c	-.08	1.00								
4. HOT	.79	.41	.33 ^d	-.04	.08	1.00							
5. R&D	.60	.23	.40 ^d	.41 ^d	.04	.10	1.00						
6. CITATION	139.37	196.91	.18 ^b	.19 ^b	-.04	.09	.22 ^b	1.00					
7. ASSET	10323397	10069583	.52 ^d	.11	.28 ^c	.03	.25 ^c	.15 ^a	1.00				
8. PRODS	3.30	4.26	.31 ^d	.16 ^a	.17 ^a	.02	.35 ^d	.11	.08	1.00			
9. EXP	.70	.22	-.04	-.14 ^a	.16 ^a	-.03	-.01	-.00	-.04	.05	1.00		
10. PATENT	3.30	4.85	-.03	-.06	.15 ^a	.06	.09	-.00	-.07	.41 ^d	.05	1.00	
11. CONTRAC	4.97	4.15	.13	.17 ^a	.12	.02	.35 ^d	.50 ^d	.15 ^a	.08	.03	-.04	1.00

a. $p < .10$. b. $p < .05$. c. $p < .01$. d. $p < .001$.

Exhibit 4
Regression Results

Independent Variables	Dependent Variables			
	Day	Week	Month	
EDUCAT	-.06	-.05	.02	
TMTCOMP	.03	.05	.17 ^a	
HOT	.27 ^c	.26 ^c	.29 ^d	
R&D	.21 ^b	.22 ^b	.20 ^b	
CITATION	.08	.09	.07	
ASSET	.46 ^d	.46 ^d	.39 ^d	
PRODS	.23 [*]	.21 ^b	.24 ^b	
EXP	.01	-.02	-.04	
PATENT	-.09	-.11	-.16 ^a	
CONTRAC	-.04	-.07	-.08	
Adj. R ²	.43	.42	.45	
F-statistic	7.85 ^d	7.61 ^d	8.30 ^d	
N	91	91	91	

a. $p < .10$. b. $p < .05$. c. $p < .01$. d. $p < .001$.

the company's scientific capabilities because Scientific Advisory Board members are typically not full-time employees and largely act as consultants to the top management team. Scientific capabilities also appear more important to investors than top management team variables. Only the completeness of the top management team was significant in the third model. This is surprising given the wealth of evidence relating TMT variables with various outcomes.⁶⁴ One possibility is that the value of a biotechnology firm is carried almost totally in its scientific knowledge and commercialization capabilities rather than the demographics of its top management team.

While the results provide strong support for the conclusions, the focus on biotechnology firms raises questions about the generalizability of the findings. Despite the unique characteristics of the biotechnology industry, we believe the results are generalizable. Basic science appears to be playing a greater role in the success or failure of individual firms.⁶⁵ This increases the importance of scientific capabilities to investors in all types of

high-technology firms, and the importance of effectively signaling these capabilities to investors by entrepreneurs interested in taking their companies public.

While we have found strong empirical support for the model, there is still a significant amount of variation in the market value of the firm that is unexplained. Obviously there remain other variables which demand further study. One particular avenue of investigation should include a much closer examination of the TMT. Factors such as industry experience and previous entrepreneurial activity may be valued by investors especially when investors have very little specific knowledge regarding the development and commercialization of a product. Additional research needs to expand this study by including firms from other industries. Finally, the value of the initial stock of resources needs to be measured at other points in time such as at the end of the first year of trading to determine if and when this initial stock of assets begins to lose its value.

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Paint-Your-Own Pottery Case Study

Lisa Morin

There are currently more than seventy paint-your-own pottery shops in the United States. Although the concept of such studios is fairly new to New England, they have been in existence on the West Coast for years.

Isabelle and Madeline were best friends who met in college. They had not seen each other in months and decided to meet one Saturday, halfway between their homes in Avon and Moodus, Connecticut. After a big hug, Isabelle and Madeline walked into Amazing Glaze on a cool, crisp spring day. Isabelle had been to Color Me Mine, a paint-your-own-pottery studio in California and was sure that Madeline would love the experience of coloring and firing a clay piece that had already been formed by a pottery professional.

It was both their first time to Amazing Glaze. The atmosphere was comfortable and casual, so they could catch up on each other's busy lives, as they became involved in their artistry. Both young women were charged with energy because they knew they would have a beautiful pottery piece at a reasonable cost to take home and remember for years to come.

Background

Paint-your-own-pottery studios are still fairly new to the East Coast. Yet, they have been in development on the West Coast for years. Color-Me-Mine, a 1996 Los Angeles-acquired division of Koo Koo Roo California Kitchen, was purchased to combine the pottery and food industries for the company. The basic concept that people would get thirsty and hungry when spending over two hours doing pottery painting, increased the sales in their neighboring café by 13 percent in the days after the pottery studio opened. The owner sees the studio as "a form of relaxation, a you-deserve-a-break-today kind of thing."¹

There are currently more than seventy such pottery shops in various locations in the country. Petroglyph, located in Santa Cruz, California, likes

to call itself a "pottery bar." At Petroglyph, the process a customer follows to complete a piece of pottery is similar to that followed at other studios. The first step is for the consumer to choose a mug, plate, pasta bowl, frame, or other piece of already molded and once-fired piece of pottery from the kiln. Next, the customer picks as many beautiful rainbow color paints as he wants and starts painting on the pottery's surface.

Once the crafter is finished with his masterpiece, he passes it on to a staff member. The studio will then give it a final firing. The customer's finished piece will be ready for pick up within a week.

Forbes recently described pottery shops as: "Self-expression for the time-deprived, made fast and simple! You get the feeling of creation without most of the agonies and study that true creativity exacts."² "One of Petroglyph's coowners commented. "It's fast and it's useful. No matter how badly you paint a bowl, you can still have cereal in it. It caters to that desire of not having to commit."³

Roll Out into the New England Market

In addition to Amazing Glaze, there are numerous paint-your-own-pottery studios entering other New England urban markets. The idea for Amazing Glaze came to Renee, one of the coowners, after she visited her sister in California. She came across Color-Me-Mine and was positive it could be a successful venture in Connecticut, her home state. Renee and a close friend left their corporate jobs and formed Amazing Glaze, a limited liability corporation. They renovated an old house that was previously a doctor's office in downtown Avon. Their hope for the future is to have picnic tables out front and beverages and snacks available for their customers.⁴

Come Out & Clay is located on a main street in South Norwalk, Connecticut. The studio's success can be measured by the fact that they recently opened a shop in Mamaroneck, New York, and one a short distance down the road from Amazing Glaze in West Hartford,

Connecticut. The owners are contemplating opening another studio in Stamford, Connecticut. Growth of the marketplace is positive for the industry, but competition for these small studios has the potential to make success impossible if they do not have customer loyalty to their studio.

What Does It Cost?

Isabelle and Madeline enjoyed the experience and announced to each other their creations were "wonderful" even with a distinct lack of special artistic ability. Both heartily agreed that the cost was worth it to know they had personalized their pottery in a way impossible to do with regular store pottery. In addition, the women had enjoyed a comfortable, relaxing, and enjoyable visit with each other.

Isabelle paid \$29.95 for a large pasta bowl; she had decided to sponge a beautiful sunflower in the center with bright blue speckles on the reverse side. To this day, she loves to show off her piece and her name in large bold letters on the bottom of the bowl along with the month and year. Madeline's medium fruit bowl was \$27.95. She opted to sponge the bowl completely with pastel purple, blue, and green. It is perfect for fresh fruit on her kitchen table.⁵

On average, the cost of painting is about \$8 per hour, prorated every fifteen minutes. The

minimum charge is one hour. The unpainted ceramic pieces range in price from a \$3 tile piece to \$40 for a large vase. In addition, there is a \$3 firing fee at some studios.

The Situation

Paint-your-own-pottery studios are in the introductory/early growth stage of the marketing product life cycle. Yet for success truly to be achieved by each studio, this concept needs strong awareness advertising to educate and motivate consumers to try their hands at personalizing a pottery piece. Presently, most studios have printed flyers within the stores for birthday parties, corporate motivational parties, bachelorette parties, and couples' showers. Still, many individuals have no idea that this concept exists and some who do know seem resistant to "risking" a \$30 pottery piece to their own artistic interpretations. At the time of this case study, the owners of Amazing Graze were still below breakeven and were worried about the studio's financial future.

Teaching notes are available for faculty who request them through the New England Journal of Entrepreneurship's editorial staff.

Endnotes

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4. Amazing Glaze store visit, April 26, 1997.
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6. Come Out & Clay pamphlet.

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Lisa Morin is a graduate of Sacred Heart University's MBA program. This case study was written by her in partial fulfillment of requirements for an advanced marketing course. Ms. Morin's submission was considered one of the best in the class and speaks to some of the challenges and risks in new business, entrepreneurial start-ups.

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